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Investment companies industry developments, 2010/11; Audit risk alerts

American Institute of Certified Public Accountants (AICPA)

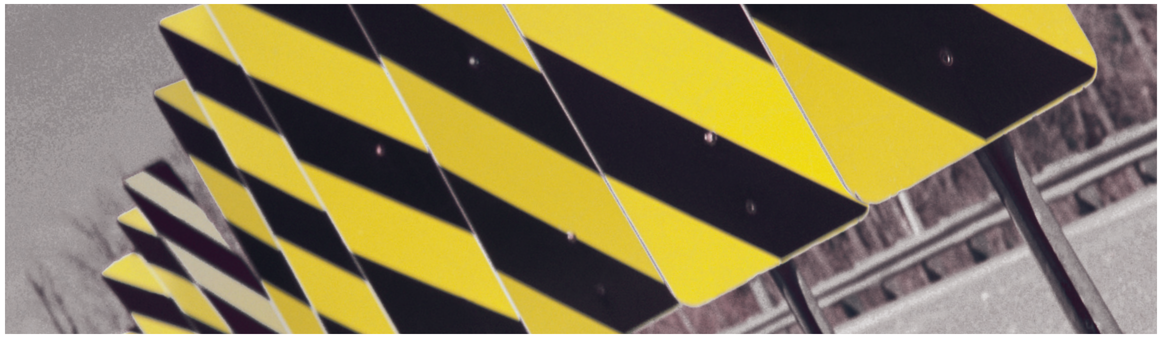
Audit Risk Alert: 2010/11 Investment Companies Industry Developments

AICPA

2010/11

Investment Companies Industry Developments

AUDIT RISK ALERT



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Notice to Readers

This Audit Risk Alert replaces *Investment Companies Industry Developments—2009*.

This Audit Risk Alert is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

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Feedback

The Audit Risk Alert *Investment Companies Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications @aicpa.org.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your investment company audits and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general current economy and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.04 The year 2010 may be the beginning of a wave of economic recovery. Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. The National Bureau of Economic Research (NBER) determined that the recession officially began in December 2007 and ended in June 2009 based on a trough of business activity that occurred in the U.S. economy in June 2009. The trough marks the end of the business cycle's declining phase and the start of its rising phase. However, the NBER did not conclude that economic conditions have turned favorable or that the economy has returned to normal capacity. It also decided that any future downturn of the economy would be a new recession, not a continuation of the recently ended recession.

.05 Further, after experiencing a considerable decline in the stock market through March 2009, the markets have rebounded substantially. In March 2009, the S&P 500 and the Dow Jones Industrial Average (DJIA) reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only a year later, all 3 had increased in value by at least 59 percent from the previous year's lows. All 3 remained relatively unmoved 6 months later, in late September 2010. However, stocks did end September on a high note; the DJIA had its biggest September gain in 7 decades, and the S&P 500 had its biggest gain since 1939. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, and Europe's economy, among other reasons. The fear of a double-dip recession (a recession followed by a short-lived recovery followed by another recession) continues to loom over the U.S. economy. The research firm, StrategyOne reported in early September that 65 percent of Americans believe a double-dip recession is likely to occur.

Key Economic Indicators

.06 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.07 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.6 percent in the second quarter of 2010 (second estimate), 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. Further, in June 2010, the Treasury reported that banks had repaid about 75 percent of the bailout money they received through the Troubled Asset Relief Program, and that taxpayers made $21 billion on the investment. However, other bailouts are not yet repaid, and they may yield losses to taxpayers.

.08 From August 2009 to August 2010, the unemployment rate fluctuated between 9.5 percent and 10.1 percent. An unemployment rate of 10.0 percent represents approximately 15.3 million people. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. However, through the end of August 2010, the rate has remained below 10.0 percent. Additionally, one reason for the continued high unemployment rate is that more Americans are resuming their search for work.

.09 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent, where it remained through September 2010. The Federal Reserve described the current economic recovery in its September 21, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising, though less rapidly than earlier in the year, and investment in nonresidential structures continues to be weak.

- Employers remain reluctant to add to payrolls.
- Housing starts are at a depressed level.
- Bank lending has continued to contract, but at a reduced rate in recent months.
- The pace of economic recovery is likely to be modest in the near term.

.10 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant its holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the beginning of the financial market turmoil in August 2007, total assets on the Federal Reserve's balance sheet have grown from $869 billion to $2.3 trillion. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

Investment Companies Industry Trends and Conditions

State of the Investment Company Industry

.11 The state of the investment company industry remains consistent with the overall state of the economy. Although the environment is not as shaky as it was during the midst of the financial crisis, the road to recovery is rocky, and some investors appear to be losing their appetite for risk.

.12 From January 2010 to August 2010, long-term stock market mutual funds experienced a net new cash outflow of $18.2 billion, according to the Investment Company Institute (ICI). Instead, investors are choosing safer investments such as bonds; the same time period had a net new cash inflow of $216.1 billion in long-term bond mutual funds (taxable and municipal). Further, long-term hybrid mutual funds experienced a net new cash inflow of $12.0 billion and money market funds experienced a net new cash outflow of $496.4 billion during the same eight months. When compared with year-to-date August 2009, all of these types of funds experienced an increase in net new cash flow, except for stock mutual funds and municipal bond mutual funds. Typically, following a recession, investors become bullish on stocks with the hope of profiting from a stock market recovery. However, even as corporate earnings have improved, investors have not rushed back into domestic stocks or domestic stock market funds. It is possible the notions in which investors historically believed—the stock market provides a safe and profitable investment, home values will always rise—have been upset by the recent financial crisis.

.13 Individual investors have become increasingly important over the past several decades as company-funded pensions have given way to individually managed 401(k) accounts for retirement. According to Hewitt Associates, a human resources consulting firm, until two years ago, 70 percent of the money in 401(k) accounts that it tracks was invested in stock funds; by January of 2009, that amount had fallen to 49 percent, as investors pushed their portfolios toward bonds. In August 2010, 57 percent of the money in 401(k) accounts was invested in stock funds; however, the increase was primarily attributable to the rise in prices as opposed to a change in investment approach. Another important factor to consider in this change of approach is the aging of the baby-boomer generation. This will skew large amounts of investment away from riskier stock funds to more conservative bonds and bond funds; these investors are looking for guaranteed income during their later years. Another possible factor behind investment withdrawals might be the growing demand for cash among those unable to find a job or obtain a home-equity loan. Further, as reported by Fidelity Investments, during the second quarter of 2010, a record number of workers made hardship withdrawals from their retirement accounts; also, the number of workers borrowing from their accounts reached a ten-year high.

.14 According to the ICI, from January 2010 through August 2010, the total net assets of the nation's mutual funds decreased by $346.3 billion or 3.1 percent. Of this total decrease,

- stock funds' total net assets decreased $244.7 billion (-4.9 percent),
- hybrid funds' total net assets increased $12.6 billion (2.0 percent),
- taxable bond funds' total net assets increased $318.4 billion (18.2 percent),
- municipal bond funds' total net assets increased $56.2 billion (12.3 percent),
- taxable money market funds' total net assets decreased $427.5 billion (-14.6 percent), and
- tax-free money market funds' total net assets decreased $61.3 billion (-15.4 percent).

Derivatives Related Disclosures

.15 In early 2010, the Securities and Exchange Commission (SEC) staff announced a review to evaluate the use of derivatives by mutual funds, exchange-traded funds (ETFs), and other investment companies. Until the review is complete, the staff has deferred consideration of exemptive requests under the Investment Company Act of 1940 (the 1940 Act) to permit ETFs that would make significant investments in derivatives. This decision affects both new and pending exemptive requests from certain actively managed and leveraged ETFs that particularly rely on swaps and other derivative instruments to achieve their investment objectives. This review will explore numerous issues related to the use of derivatives by funds, including the required derivatives-related disclosures by investment companies in registration statements and shareholder reports. Although the review was not completed at the time of this writing, in July 2010, the SEC sent a letter to the ICI with some of its observations that may give investment companies immediate guidance on ways to provide investors with more understandable disclosures related to derivatives, including the risks associated with them.

.16 The letter highlighted the following observations made by the SEC staff thus far in its study:

- Form N-1A (prospectus) derivatives disclosures could be improved because some funds provided generic disclosures that may be of limited usefulness for investors.
- The Management's Discussion of Fund Performance (MDFP) section of mutual funds' annual report to shareholders, which is intended to provide shareholders with information about the factors

that materially affected the fund's performance during its most recently completed fiscal year, did not consistently reflect material effects of derivatives on performance.

- Some funds could improve on the qualitative disclosures on the objectives and strategies regarding the use of derivatives required by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815, *Derivatives and Hedging*, in addition to other areas.

.17 On Form N-1A, the generic disclosures about derivatives had limited usefulness in evaluating the anticipated investment operations of the fund, because they lacked detail concerning how the fund's investment adviser actually intends to manage the fund's portfolio and the consequent risks. These generic disclosures took the form of either highly abbreviated disclosures with little or no explanation of the nature of the investments or, alternatively, highly technical disclosures (that is, not plain English) that provided no context to the fund's actual investment operations. Investors may not be able to distinguish which, if any, derivatives are part of the principal investment strategies of the fund or specific risk exposures they will entail. Further, they may be misled to believe a fund's exposure to derivatives is minimal due to abbreviated disclosures, when the fund actually has substantial investments in and exposure to derivatives. The opposite is also possible—that is, investors may be led to overestimate a fund's use of derivatives—when disclosures are lengthy and technical. Some fund complexes even provide the same derivatives-related disclosures for multiple funds that have significantly different exposure to derivatives. The SEC letter states that ". . . all funds that use or intend to use derivative instruments should assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner using plain English. Further, any principal investment strategies disclosure related to derivatives should be tailored specifically to how a fund expects to be managed and should address those strategies that the fund expects to be the most important means of achieving its objectives and that it anticipates will have a significant effect on its performance."

.18 The SEC staff noted that although some funds, based on their financial statements, appear to have significant derivatives exposure, their MDFPs include minimal or no discussion of the effect of those derivatives on the funds' performance. Another inconsistency noted is that some funds that had no MDFP derivatives-related disclosure, but they disclosed in their registration statements principal investment strategies that included the use of derivatives. Derivatives-related disclosures should also be made if they materially affected a fund's performance during the year—regardless of whether derivatives were held at the close of the fiscal year.

.19 Lastly, the SEC staff also noted that improvements could be made in the derivatives disclosures required by FASB ASC 815. The required qualitative disclosures could be improved by funds addressing the effect of their use of derivatives during the reporting period. The financial statements and notes should sufficiently inform shareholders how a fund actually used derivatives during the period to meet its objectives and strategies. For funds that sell protection through credit default swaps, consideration may be given to explaining the relevance of the disclosed credit spreads. Funds should also remember that identification of the counterparty is a material component of over-the-counter (OTC) derivatives and should be disclosed. The letter can be accessed at www.sec.gov/divisions/investment/guidance/ici073010.pdf. Additional comments on this issue are discussed in the "SEC Comments and Observations" section of this alert.

SEC Circuit Breaker Rules

.20 On May 6, 2010, a market disruption occurred whereby the DJIA rapidly fell almost 1,000 points. The reasons for the fall have yet to be confirmed. Approximately one month later, the SEC approved rules that will require the exchanges and the Financial Industry Regulatory Authority (FINRA) to pause trading for five minutes in certain individual stocks if the price moves 10 percent or more in either direction in a five minute period. The pause would only apply to stocks in the S&P 500 and would give the markets the opportunity to attract new trading interest in an affected stock, establish a reasonable market price, and resume trading in a fair and orderly fashion. These rules are in effect on a pilot basis through December 10, 2010. The pilot period will be used to make appropriate adjustments to the parameters or operations of the circuit breakers based on experience, and the scope of the rules will be expanded to securities beyond the S&P 500 as soon as practicable. Additionally, the SEC is considering recalibrating marketwide circuit breaker rules that were already in effect in May 2010 but were not triggered during the May 6 minicrash. By the end of June, these circuit breakers had been set off twice—both times for erroneous trades.

.21 At the end of June 2010, the SEC published for public comment proposals by the national securities exchanges and FINRA to expand the program to include all stocks in the Russell 1000 Index and certain ETFs. The markets will continue to use the pilot period to make appropriate adjustments to the parameters or operations of the circuit breakers as warranted based on their experience. ICI commented on both proposals, and in both comment letters, it explained its strong support for expanding the current pilot program to include ETFs. The latter comment letter noted that, "Excluding ETFs from circuit breakers that contain the individual securities comprising the ETFs' baskets creates risks that ETFs could again suffer disproportionately during a market event similar to that of May 6, which risks far outweigh any perceived benefits of excluding such ETFs." Both letters can be accessed from http://ici.org/policy/comments/archives/2010.

Proposed Regulations on Cost Basis Reporting

.22 In December 2009, the IRS released proposed regulations on cost basis reporting through Regulation 101896-09. For cost basis reporting purposes, anyone with tax reporting responsibility is considered a broker (that is, both mutual funds and broker-dealers would be subject to the proposed regulations). The proposed regulations relate to

- reporting sales of securities by brokers and determining the basis of securities that reflect changes in the law made by the Energy Improvement and Extension Act of 2008 that requires brokers when reporting the sale of securities to the IRS to include the customer's adjusted basis in the sold securities and to classify any gain or loss as long-term or short-term
- how taxpayers compute their basis when averaging the basis of shares acquired at different prices and their expansion of liability in that computation which reflect changes in the law

- providing brokers and others until February 15 of each year to furnish certain information statements to customers
- new reporting requirements imposed upon persons that transfer custody of stock and upon issuers of stock regarding organizational actions that affect the basis of the issued stock
- how brokers report short sales of securities that reflect changes in the law

.23 The ICI has submitted two comment letters to the IRS on these proposed regulations because the regulations raised a number of implementation and calculation issues for brokers, including mutual funds. The following specific aspects of the proposed regulations were commented on and are considered to be most important to the mutual fund industry: (*a*) average cost, (*b*) gifted and inherited shares, (*c*) flexibility for transfer statements, and (*d*) the February 15 reporting deadline.

.24 Final regulations are expected to be issued by fall 2010, and there will be an 18-month window for implementation. The proposed regulations are expected to be effective for fund shares acquired after December 31, 2011, and effective for other equities acquired after December 31, 2010. Readers should be alert for the issuance of final regulations.

Trends in Fees and Expenses of Mutual Funds

.25 Of the five key findings discussed in the ICI paper, *Trends in the Fees and Expenses of Mutual Funds, 2009*, the only increases in fees or expenses were in the expense ratios of stock funds and bond funds, which were nominal at 2 basis points each. The other four key findings included fees and expenses incurred by investors in long-term mutual funds were unchanged; rising expense ratios of long-term funds were offset by a decline in load fee payments by investors; the average fees and expenses of money market funds fell 4 basis points; and average expense ratios of funds of funds declined for the fourth consecutive year. Between 1990 and 2009, the average fees and expenses paid by investors for stock funds, bond funds, and money market funds all decreased by at least 38 percent.

.26 Regarding stock funds, the increase in fund expense ratios is not unexpected given the recent market downturn—that is, when the assets of stock funds decline, the relatively fixed expenses of funds contribute proportionally more to the ratio. If stock funds continue to recover, the expectation is that fund expense ratios will decline. For bond funds, the nominal increase in the expense ratio was driven by fees paid by some tax-exempt funds that chose to establish and draw down on lines of credit from banks rather than sell securities into depressed markets to meet various capital needs. These commitment fees and interest costs added to the expenses of these funds, which increased the industrywide average. However, the tax-exempt bond funds that implemented this strategy were generally the best performing funds in their class during 2009.

.27 The drop of 4 basis points in the fees and expenses of money market funds was attributable both to a decline in expense ratios among individual funds and an increase in market share of institutional money market funds. Although both types of funds saw decreases in expense ratios, the decrease from the institutional money market funds had a stronger effect because those funds continue to gain market share (2/3 of the assets in all money market funds by the end of 2009) and, generally speaking, have lower expense ratios than retail money market funds. This is typically the case because retail funds have more investors with smaller average account balances.

.28 The two primary types of funds of funds are lifestyle and lifecycle. Lifestyle and lifecycle funds of funds account for 61 percent of the total number and 68 percent of the total assets of funds of funds. The decrease in expense ratios of funds of funds was nominal from 2008 to 2009, but the decrease between 2005 and 2009 was 10 basis points. This is equally attributable to a decrease in expense ratios of individual funds and an increase in market share of lower-cost funds and other factors.

Proposal for Mutual Funds That Invest in Futures Contracts to Register With the Commodity Futures Trading Commission

.29 In June 2010, the National Futures Association (NFA) proposed that commodities funds that invest in futures contracts register with not only the SEC but also the Commodity Futures Trading Commission (CFTC). *Futures contracts* are leveraged derivatives whose value is linked to the future value of markets from commodities to interest rates. The NFA is an industry-funded watchdog for futures investors that had this power until 2003; the underlying rationale for the funds to be dually registered is that it would help boost disclosure to investors about what these funds invest in and make fees and costs more readily apparent. However, it will not change what the funds can buy, nor will it alter the recourse investors have if things go awry. Some concerns that have been voiced relate to the additional burden in terms of compliance work and costs, the different regulatory framework of the CFTC as compared with the SEC, delays in the fund registration process, and increased confusion of two regulators. As of this writing, the CFTC has not identified a timeline for action.

Legislative and Regulatory Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.30 On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law in response to weaknesses in the financial services industry that are believed to have contributed to the recent recession. The Dodd-Frank Act was approved by the House on June 30, before narrowly clearing the Senate on July 15. As the economy is slowly recovering from the worst economic downturn since the Great Depression, this reform represents the greatest change to financial regulation since that time. It ends the era of hands-off regulation and increased deregulation of the financial services industry. The two main goals of the reform are to lower the systemic risks to the financial system and to enhance consumer protections.

.31 The Dodd-Frank Act, among many other changes, will create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisers. It mandates more than 60 different studies and reports by various oversight agencies on a range of issues. Because these new regulations will most likely be produced over the next few years, the impact of these reforms will be staggered. This will provide opportunities for the financial services industry to respond to the proposed regulations and work with regulators in developing reporting requirements, formats, and timetables that are practical to implement. Additionally, this will enable both regulators and the industry to meet their individual goals, which is important to the efforts to avoid market disruptions and inadvertently increase systemic risk. Large, complex institutions, in particular, and newly regulated entities with new reporting requirements will be challenged to update their systems and data infrastructures. Although the Dodd-Frank Act contains many provisions, some highlights that may be of particular interest to auditors are summarized in the following sections.

Financial Stability Oversight Council

.32 The Dodd-Frank Act creates a new systemic risk regulator called the Financial Stability Oversight Council (FSOC). The two main goals of the FSOC are to identify risks to the financial stability of the United States and promote market discipline by eliminating the expectation of "too big to fail." To meet these goals, the FSOC has many powers, and it will identify any company, product, or activity that could threaten U.S. financial stability. The FSOC has the power to designate nonbank financial entities as systemically important and, through the Office of Financial Research (OFR), may collect reports from any bank holding entity or nonbank financial entity for the purpose of determining whether it poses a threat to U.S. financial stability. These entities will be under the supervision of the Federal Reserve. Foreign nonbank financial entities may also be identified for heightened supervision and regulation. The new OFR is targeted to be established and fully operational no later than one year after enactment. The FSOC will be chaired by the Secretary of the Treasury, and members will be heads of regulatory agencies, including the chairmen of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the SEC, among others. The first meeting of the FSOC will be in October 2010. For those large entities deemed a threat to U.S. financial stability, the FSOC can, under the authority of a new orderly liquidation authority, authorize the FDIC to close such entities. Upon enactment of the Dodd-Frank Act, the FSOC, through the Federal Reserve, will also have the power to preemptively require a large, complex entity to divest some of its holdings if it poses a grave threat to the stability of the United States, although this is intended only as a last resort.

.33 The FSOC will make recommendations to the Federal Reserve to impose increasingly stringent capital, leverage, liquidity, risk management, and other requirements as entities grow in size and complexity, with significant requirements for entities that pose a risk to the financial system. These standards must include risk-based capital requirements and leverage limits, unless the Federal Reserve, in consultation with the FSOC, determines that such requirements are not appropriate for an identified nonbank firm "because of the activities of such entity (such as investment company activities or assets under management) or structure, in which case the [Federal Reserve] should apply other standards that result in similarly stringent risk controls." Final rules must be made by the Federal Reserve no later than 18 months after enactment. The current level of minimum leverage capital requirements is to be the floor for the future capital requirements to be developed.

.34 Financial entities will be required to conduct "stress tests" (as defined by the primary regulators). For bank holding companies with total consolidated assets of at least $50 billion and identified nonbank firms, the testing will be done semiannually; annual testing will be required of other financial entities that have total consolidated assets exceeding $10 billion and are regulated by a primary federal financial regulatory agency.

.35 New and stricter capital requirements will have differing effects on financial entities. Some may move toward lower-margin businesses that are less capital intensive, but others may continue to strive for higher returns. Further, new forms of capital, such as contingent capital, may be considered a possibility. This capital would effectively be subordinated, and other forms of debt that convert to common equity under prescribed conditions may be considered. Low interest rates and government support have helped many entities build up their capital. Some rating agencies have said that without this assistance, many entities would have lower credit ratings, and as the new rules are implemented, some may experience downgrades. Entities will likely be considering new ways to build and maintain capital or shed troubled assets. The FSOC has the ability to veto rules created by another new regulator, the Bureau of Consumer Financial Protection (BCFP), with a two-thirds vote.

Bureau of Consumer Financial Protection

.36 The new BCFP consolidates most federal regulation of financial services offered to consumers. The director of the BCFP replaces the director of the Office of Thrift Supervision (OTS) on the FDIC board. Almost all credit providers, including mortgage lenders, providers of payday loans, refund anticipation loan providers, other nonbank financial companies, and banks and credit unions with assets over $10 billion, will be subject to the new regulations. The BCFP has no authority to exercise any power to enforce the legislation with respect to SEC-regulated persons. This exclusion specifically applies to registered investment companies, registered investment advisers, registered broker-dealers, and registered transfer agents, among others. Also excluded from the BCFP's jurisdiction are 401(k) and other retirement plans.

.37 The BCFP has the authority to examine and enforce regulations for banks and credit unions with assets of over $10 billion and all mortgage-related businesses (lenders, servicers, and mortgage brokers, including regulations to crack down on foreclosure scam operators), providers of payday loans, and student lenders, as well as other nonbank financial entities that are large, such as debt collectors and consumer reporting agencies. Banks and credit unions with assets of $10 billion or less will be examined for consumer compliance by the appropriate regulator. The BCFP also is able to autonomously write rules for consumer protections governing all financial institutions (banks and nonbanks) offering consumer financial services or products.

.38 The Dodd-Frank Act recognizes that CPAs providing customary and usual accounting activities (which include accounting, tax, advisory, or other services that are subject to the regulatory authority of a state board of accountancy), and other services incidental to such customary and usual accounting activities are already adequately regulated and, therefore, are not subject to the BCFP's authority.

.39 A national consumer complaint hotline will be created so that consumers will have, for the first time, a single toll-free number to report problems with financial products and services. Functions currently handled by existing agencies are expected to be transferred to the BCFP, and the BCFP is expected to assume full authority for consumer financial protection no later than one year after enactment.

Ending "Too Big to Fail" Bailouts

.40 The Dodd-Frank Act is intended to reduce the risk that large firms will take excessive risk because they believe they are, in effect, guaranteed to be bailed out in the event of failure. Bailouts like this occurred during the recent economic recession. Although that is one intent of the specific changes required by this reform, whether that goal will be achieved can only be determined over time. The desired result is that taxpayers will not again be responsible to save a failing financial entity or cover the cost of its liquidation.

.41 Under the Dodd-Frank Act's new so-called Volcker Rule, a banking entity will be restricted in its proprietary trading; will be prohibited from acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and be prohibited from sponsoring a hedge fund or private equity fund. The term *sponsor* when used with respect to a hedge fund or private equity fund includes an entity

- serving as a general partner, managing member, or trustee of the fund;
- selecting or controlling a majority of the directors, trustees, or management of the fund; and
- sharing the same name (or a variation of the same name) with the fund for corporate, marketing, promotional, or other purposes.

.42 Final rulemaking on the Volcker Rule must be no later than nine months after the FSOC's recommendations on implementation considerations. *Proprietary trading* consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients; that is, the entity is using its own money to place directional market bets that are unrelated to serving customers. Some of the benefits to bank entities of proprietary trading, which will now be restricted, include the following:

- Allows the entity to profit on its own instead of collecting commissions and fees from clients
- Allows the entity to build an inventory of securities, which can be useful if a client places a trade in an illiquid market
- Allows the bank to make a market when it is assigned to ensure the liquidity for a given security

.43 A major bank estimated that 10 percent of its revenue came from proprietary trading, but that figure may vary depending on the size and complexity of the institution. There are limited exceptions to the restrictions on proprietary trading, such as transactions in government securities, agency securities, and state and municipal obligations; certain risk-mitigating hedging activities on behalf of the covered banking entity; transactions on behalf of customers; the sale or securitization of loans in a manner otherwise permitted by law; and investments in small business investment companies and other entities devoted to the public interest. Banks are allowed to make *de minimis* investments in hedge funds and private equity funds, using no more than 3 percent of their tangible common equity in all such funds combined. Also, a bank's investment in a private fund may not exceed 3 percent of the fund's total ownership interest. Nonbank financial institutions supervised by the Federal Reserve will also have restrictions on proprietary trading, hedge fund investments, and private equity investments.

.44 The Dodd-Frank Act also requires large, complex financial entities to periodically submit plans for their rapid and orderly shutdown should the company go under (a "funeral plan" or "living will"). No later than 18 months after enactment, the Federal Reserve Board and the FDIC must issue final rules implementing the resolution plan requirement. Entities that fail to submit acceptable plans will have higher capital requirements and restrictions on growth and activity, as well as divestment. This will create an increased focus on entity-level financial and operational concerns for these large, complex entities.

.45 Additionally, an orderly liquidation mechanism for the FDIC to unwind failing systemically significant financial entities that pose a risk to the financial system has been created. The mechanism provides that shareholders and unsecured creditors bear losses and management and culpable directors will be removed. The FDIC will only be allowed to borrow funds to liquidate an entity when it expects to be repaid from the assets of the entity being liquidated, and the government will be first in line for repayment. Funds that are not repaid from the sales of the entity's assets will be repaid first through the clawback of any payments to creditors that exceeded liquidation value and then through assessments on large financial entities (with the riskiest ones paying more). Taxpayers will bear no cost for liquidations, and the Federal Reserve will no longer be able to provide "open institution" assistance by making emergency "bail-out" loans to it. Consistent with the treatment of financial contracts in a resolution by the FDIC of an insured depository institution, the Dodd-Frank Act allows for a delay of up to one business day in the enforcement of "qualified financial contracts," including repurchase agreements. To prevent bank runs, the FDIC can guarantee debt of solvent insured banks, but only after meeting serious requirements.

Sarbanes-Oxley Section 404(b) Exemption

.46 The Dodd-Frank Act amends SOX to make permanent the exemption from its Section 404(b) requirement for nonaccelerated filers (those with less than $75 million in market capitalization) that had temporarily been in effect by order of the SEC. Section 404(b) of SOX requires companies to obtain an auditor's report on management's assessment of the effectiveness of the company's internal control over financial reporting. In September 2010, the SEC issued Final Rule Release Nos. 33-9142; 34-62914, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, to conform its rules to this resulting change from the Dodd-Frank Act.

.47 The Dodd-Frank Act also requires the SEC to complete a study within 9 months of the act's enactment on how to reduce the burden of Section 404(b) SOX compliance for companies with market capitalizations between $75 million and $250 million. The study will consider whether any such methods of reducing the burden, or a complete exemption, would encourage companies to list on U.S. exchanges.

Auditors of Broker-Dealers

.48 The Dodd-Frank Act also provides for the PCAOB to create a program for registering and inspecting the auditors of broker-dealers, including standard setting and enforcement. Currently, all auditors of broker-dealers must be registered with the PCAOB. The Dodd-Frank Act allows the PCAOB, in its inspection rule, to differentiate among broker-dealer classes and to potentially exempt introducing brokers, such as those who do not engage in clearing, carrying, or custody of client assets.

.49 The SEC published Interpretation Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, to clarify the application of certain SEC rules, regulations, releases, and staff bulletins in light of the previously referenced authority granted to the PCAOB in the Dodd-Frank Act. The SEC is considering a rulemaking project to update the audit and related attestation requirements under the federal securities laws for brokers and dealers, particularly in light of the Dodd-Frank Act.

.50 In addition, the PCAOB has not yet revised its rules, which currently refer only to issuers, to require registered public accounting firms to comply with PCAOB standards for audits of nonissuer brokers and dealers. As a result, the SEC is providing transitional guidance with respect to its existing rules regarding nonissuer brokers and dealers. Specifically, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to nonissuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the United States, plus any applicable rules of the SEC. The SEC intends to revisit this interpretation in connection with its rulemaking project referenced previously.

Derivatives Trading

.51 The Dodd-Frank Act provides the SEC and the CFTC with the authority to regulate OTC derivatives and requires central clearing and exchange trading for derivatives that can be cleared. The SEC will have authority over security-based swaps (including credit default swaps). The CFTC will have authority over all other swaps, including energy-rate swaps, interest-rate swaps, and broad-based security group or index swaps. Standardized swaps will be traded on an exchange or in other centralized trading facilities, which will promote transparency; standardized derivatives will also have to be handled by central clearinghouses. *Cleared* describes when trades are routed through a central clearinghouse that covers losses if a party to the trade is unable to complete the transaction. As a safeguard, many derivative traders will also be required to post margin to ensure all obligations can be paid and to offset the general risks that derivative trading poses to the financial system. Clearing and exchange trading requirements are expected to become effective 360 days following enactment. The Dodd-Frank Act prohibits "federal assistance," including federal deposit insurance and access to the Federal Reserve discount window, for any "swaps entity" with respect to any swap or security-based swap or other activity of the swaps entity.

.52 The Dodd-Frank Act also provides regulators with the authority to impose capital and margin requirements on swap dealers and major swap participants, not end users. Rules prescribed by the CFTC or the SEC must be promulgated no later than 360 days after enactment. By making the market more transparent, the pricing of common kinds of derivatives from the open marketplace may be reduced and would allow a wider range of entities to hedge their risks; customized derivatives could still have higher prices. The credit exposure from derivative transactions will be added to banks' lending limits.

However, the new rules may increase some costs of derivative trading because the increased transparency and price competition between securities dealers, may reduce dealer profit margins, causing them to charge a higher trading fee. Banks are allowed to continue engaging in principal transactions involving interest-rate, foreign-exchange, gold, silver, and investment-grade credit default swaps, subject to Volcker Rule limitations on proprietary trading. For commodities, most other metals, energy, and equities, banks will have to shift their swap operations to a separately capitalized affiliate within the holding entity. Under an end user exemption, nonfinancial firms can still use derivatives to hedge and manage the commercial risks associated with their businesses.

Accounting Standards

.53 The Dodd-Frank Act gives the FSOC the duty to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress to make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets. The FSOC may submit comments to the SEC and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure.

Credit Rating Agencies

.54 Section 939A of the Dodd-Frank Act requires federal agencies to review regulations that require an assessment of the credit-worthiness of a security or money market instrument and contains references to or requirements regarding credit ratings. In addition, the agencies are required to remove such references and substitute in their place uniform standards of credit-worthiness, when feasible.

.55 In August 2010, the SEC issued a no-action letter to ICI discussing the effect this requirement of the Dodd-Frank Act would have on the February 2010 amendments to Rule 2a-7 of the 1940 Act. Specifically, the amendments to Rule 2a-7 require boards of directors of money market funds to designate at least four nationally recognized statistical rating organizations (NRSROs) whose ratings the fund would use to determine the eligibility of portfolio securities under the rule. These NRSROs would likely need to be designated by the fall of 2010 by the boards of directors to meet the December 31, 2010, compliance date. The effect of Section 939A would be to render boards' determinations made this fall irrelevant several months later when the SEC is required to eliminate the relevant references to credit ratings. The no-action letter explains that the Division of Investment Management would not recommend that the SEC institute an enforcement action under Section 2(a)(41) of the 1940 Act and Rule 2a-4 and Rule 22c-1 thereunder if a money market fund board does not designate NRSROs and does not make related disclosures in its statement of additional information before the SEC has completed the review of Rule 2a-7 required by the Dodd-Frank Act and has made any modifications to the rule. Until the SEC determines to modify Rule 2a-7 in accordance with Section 939A of the Dodd-Frank Act, money market funds relying on this letter must continue to comply with the obligations for determining and monitoring eligible securities set forth in Rule 2a-7 as in effect before May 5, 2010 (other than the limitation on holding unrated asset backed securities rescinded by the 2010 rulemaking). The no-action letter can be accessed at http://sec.gov/divisions/investment/noaction/2010/ici-nrsro081910.htm.

Registered Investment Advisers and Hedge Funds

.56 Currently, the Investment Advisers Act of 1940 requires investment advisers with more than $30 million in assets under management to register with the SEC. Under the new reform, this threshold for federal registration will be raised to $100 million, with certain exceptions. This change will increase the number of small advisers under state supervision and allow the SEC to focus on newly registered hedge fund advisers. Advisers will provide information about their trades and portfolios necessary to assess their systemic risk. The exemption in the Investment Advisers Act of 1940 for advisers with fewer than fifteen clients has also been eliminated. Although that exemption has been eliminated, the Dodd-Frank Act will create several new exemptions from the registration requirements for advisers to private funds. These exemptions will be for midsized private fund advisers (those with assets under management in the United States of less than $150 million), venture capital fund advisers (to be defined by the SEC), foreign private advisers, family offices (to be defined by the SEC), commodity trading advisers, small business investment companies, and intrastate advisers. The new registration requirements will become effective one year after enactment; however, any investment adviser may, at the discretion of the investment adviser, register with the SEC during that one-year period.

.57 The Dodd-Frank Act gives the SEC authority to require registered investment advisers to maintain such records, and file such reports, regarding private funds advised by the adviser as necessary and appropriate in the public interest and for the protection of investors or, notably, for the assessment of systemic risk by the FSOC. The required records and reports that the SEC has the authority to require for each private fund include a description of the amount of assets under management (AUM) and use of leverage, counterparty credit risk exposures, trading and investment positions, valuation policies and practices of the fund, types of assets held, side arrangements or side letters, trading practices, and such other information as the SEC in consultation with the FSOC determines necessary or appropriate in the public interest. This may include the establishment of different reporting requirements for different classes of fund advisers based on the type or size of the private fund being advised. These potential additional disclosure requirements will likely facilitate additional SEC scrutiny of potential conflicts of interest, investor disclosures, and valuation matters. These possible requirements are still subject to the final rule making by the SEC.

.58 Investment advisers, now including those advising hedge funds, must take steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the commission may, by rule, prescribe. The Dodd-Frank Act also raises the standard for individuals to qualify as accredited investors, a basic threshold for purchasing private investments; these investors must now have $1 million, excluding the value of their primary residence. This amount will be adjusted for inflation. The prior standard was simply $1 million.

SEC and Investor Protections

.59 Because it lowers the legal standard from "knowing" to "knowing or reckless," the Dodd-Frank Act may make it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934, the 1940 Act, and the

Investment Advisers Act of 1940. This change will increase the difficulty for a defendant to fight a civil enforcement action because the SEC no longer has to show that the person intended to aid another person's violation. It only must demonstrate that the defendant's reckless conduct furthered the violation. The SEC and the Department of Justice will also now have the authority to bring civil or criminal law enforcement proceedings involving transnational or extraterritorial securities frauds. Additionally, the Dodd-Frank Act authorizes two studies on these matters. One of the studies directs the Government Accountability Office to investigate the impact of authorizing private rights of action for aiding and abetting claims and to release its findings within one year. The second study directs the SEC to examine whether private rights of action should be authorized for transnational or extraterritorial claims and is to be completed within 18 months.

.60 The Dodd-Frank Act gives the SEC the authority to impose a fiduciary duty on brokers who give investment advice (that is, the advice must be in the best interest of their customers—currently, this applies to investment advisers). Currently, brokers are only required to recommend investments that are suitable for customers. The SEC must first study this issue and deliver a report to Congress on the costs and benefits. The Office of the Investor Advocate (OIA) will also be created within the SEC to identify areas in which investors have significant problems dealing with the SEC and to provide investors with assistance. Another responsibility of this office will be to identify areas in which investors would benefit from changes in SEC regulations. The OIA must submit its first annual report to Congress no later than June 30, 2011.

.61 A whistle-blower program, with rewards to encourage securities violations reports, was created by the Dodd-Frank Act. An exception is provided for any whistle-blower who gains information through the performance of an audit of financial statements. Employers are prohibited from retaliating against whistle-blowers. Subsidiaries and affiliates that are consolidated with public companies for financial accounting purposes will become subject to the whistle-blower protections in SOX.

.62 The SEC is permitted to use fee collections to establish a reserve fund of up to $100 million that can be used to fund special projects. The SEC may submit its annual budget directly to Congress without requiring the prior approval of the White House. The SEC has publicly stated that it will need to hire approximately 800 additional people to carry out the new reforms (given the new required enforcement, the five offices created within the SEC, and the studies to be carried out) and to develop the specifics of new regulations.

Executive Compensation

.63 The Dodd-Frank Act requires a nonbinding shareholder vote on executive pay and golden parachutes for public companies. Although the vote is nonbinding, a "no" vote by shareholders would likely force management to respond in some way and can still have a beneficial effect. Every institutional investment manager will be required to disclose these advisory votes, unless (as with registered investment companies) they are already required to disclose such votes. Broker discretionary voting in uncontested director elections for all listed entities except for registered investment companies is prohibited. Consistent with current New York Stock Exchange rules, discretionary broker voting in uncontested director elections for registered investment companies is permitted. At a public company's first shareholder meeting following the end of the six month period after enactment, management must give shareholders the opportunity to vote on how frequently shareholders will have a "say on pay" (that is, annually, every two years, or every three years).

.64 The SEC now has the authority to grant shareholders proxy access to nominate directors, which is intended to help shift management's focus from short-term profits to long-term growth and stability. However, shareholders would need to exercise this right for it to have any possibility of an impact. The SEC is allowed to exempt small businesses from this requirement. The SEC issued the final proxy access rule, Final Rule Release No. 33-9136, *Facilitating Shareholder Director Nominations*, in August 2010. The rule will facilitate the effective exercise of shareholders' traditional state law rights to nominate and elect directors to company board of directors. The new rules will require, under certain circumstances, a company's proxy materials to provide shareholders with information about, and the ability to vote for, a shareholder's, or group of shareholders', nominees for director. The Dodd-Frank Act also requires entities to disclose in their annual proxy statement the median of annual total compensation to all employees, other than their CEO; the annual total compensation of the CEO; and the ratio of these two amounts. Disclosure is also required regarding why the chairman of the board and CEO positions are separate or combined.

.65 Federally regulated financial institutions with more than $1 billion in assets will be required to disclose incentive-based compensation arrangements to their federal regulator. The federal financial regulators, jointly, will prohibit any types of incentive-based compensation arrangement that they determine encourage inappropriate risks by covered financial institutions. Issuers, including registered investment companies, will be required to disclose whether employees or directors may hedge or offset any decrease in the market value of equity securities they hold in the entity.

.66 Compensation based on financial statements that are restated must be returned for the three years preceding the restatement in an amount equal to the excess of what would have been paid under the restated results. This is required regardless of whether the executive was involved in the misconduct that led to the restatement. The SEC will require the national securities listing exchanges to enforce the compensation policies. This provision should not affect registered investment companies as issuers. The Dodd-Frank Act also requires directors of compensation committees to be independent of the entity (*independent* as defined by its exchange) and its management. The members of that committee are required to select consultants, legal counsel, and other advisers only after taking into account independence factors established by the SEC. The SEC will write these rules, which are required to be final no later than 360 days after enactment. New disclosures regarding compensation will also be required, such as the incentive-based compensation policies. Further, the SEC is required to clarify disclosures on compensation, including requirements to provide information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.

.67 Overall, the level and complexity of the relationships that entities have with their regulators will increase because of the passage of the Dodd-Frank Act. Already, many firms have chief risk officers who sit above any risk management structures inside business units and try to manage the firm's overall risk profile. This position is important because it creates a single senior point of contact for regulators seeking a high-level understanding of where a firm may have risk concentrations with possible systemic implications. Entities that do not have this position will likely reconsider the creation of one.

Other Requirements and Additional Information

.68 The OTS, which is currently the regulator for savings-and-loan financial institutions, will be abolished under the Dodd-Frank Act. Under the Dodd-Frank Act, such institutions will now be regulated by the Office of the Comptroller of the Currency, which also regulates federally chartered banks. A copy of the full Dodd-Frank Act, as signed by the president, can be found at www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/ BILLS-111hr4173ENR.pdf. The AICPA is also following any developments related to the Dodd-Frank Act on our website at www.aicpa.org under "Advocacy—Federal Issues."

SEC Comments and Observations

Disclaimer: The following comments represent the views of the accounting staff of the SEC's Division of Investment Management and do not necessarily reflect the views of the commission or other members on the commission's staff. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff. This is not intended to be a comprehensive list.

General

.69 The SEC staff encourages consultation on unique or difficult accounting and reporting issues. To facilitate the consultation process, the SEC has a dedicated e-mail address (imoca@sec.gov) and a dedicated phone number (202-551-6918).

.70 Section 408 of SOX requires the SEC to review financial statements of all registrants at least once every three years. For investment companies, the review process is performed by a dedicated group in the Division of Investment Management, who review the financial statements of an entire complex. The staff will also take the opportunity to review related financial statements when a Form N-14 related to business combinations is filed. Often, for investment companies, staff comments are provided verbally to either an internal or external attorney representing the fund organization; the staff encourages accountants within fund organizations to participate in those conversations, as direct communication avoids misunderstandings about accounting-related comments.

Consolidation and Investees

.71 Rule 6-03(c) of Regulation S-X states that "[financial] statements of [an investment company] may be consolidated only with [financial] statements of subsidiaries which are investment companies." However, the SEC staff has not objected to consolidation of noninvestment company subsidiaries in certain cases (see letters to Fidelity Select Portfolio, April 29, 2008, and NGP Capital Resources Company, December 28, 2007). The staff has recently become aware of certain special purpose vehicles (SPVs) that typically would be consolidated under FASB ASC 810, *Consolidation*, but have not been consolidated based on Rule 6-03(c). The staff encourages registrants to consider the substance as well as the form of the relationship between the investment company and SPVs and whether consolidation more appropriately reflects overall financial position and results of operations.

.72 The staff has also observed an increase in the number of registrants making significant investments in nonregistered investment companies. The staff has requested, if the registered investment company's investment in the nonregistered investment company exceeds 25 percent of the fund's net assets, inclusion of the nonregistered company's financial statements as part of the registered investment company's shareholder report. Further, the nonregistered company's financial statements would be required to meet the form and content requirements of Regulation S-X, including a Schedule of Investments to the same level of detail as for the registered investment company itself (that is, both presenting either complete schedules of investments in the shareholder report under Rule 12-12 of Regulation S-X, or condensed schedules under Rule 12-12C of Regulation S-X in the shareholder report together with complete schedules in the registered company's Form N-CSR filing).

Fair Valuation

.73 The volume of changes and updates in FASB's fair valuation standards (FASB ASC 820, *Fair Value Measurements and Disclosures*) has resulted in differing levels of disclosure of valuation policies, including inputs and assumptions, among fund complexes. The SEC staff noted that FASB's intent is for the granularity of disclosure to increase as the valuations increasingly become based on less observable factors.

.74 The staff has received questions on the effective dates of the additional disclosures on transfers adopted as part of Accounting Standards Update (ASU) No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. The stated effectiveness is for fiscal years and interim periods beginning after December 15, 2009. The staff observed that this reporting convention is similar to that provided in FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, and should be understood in a similar manner, as requiring adoption for any interim period beginning after December 15, 2009, including the final interim period for the year. Thus, for example, a fund with a fiscal year-end of November 30, 2010, would adopt the standard for its Form N-Q filing for the quarter ended August 31, 2010, as well as its November 30, 2010, annual report, because the final six months of the year represent an interim period beginning after December 15, 2009.

.75 The recent FASB financial instruments exposure draft, which would require investment companies to report all liabilities, including term debt, at fair value, had raised questions about whether fair value or contractual amounts outstanding would be used to calculate asset coverage under Section 18 of the 1940 Act. The staff expressed its view that these tests should be calculated based on the contractual amounts outstanding.

Derivatives

.76 In relation to the July 30, 2010, letter issued to the ICI (http://sec.gov/divisions/investment/guidance/ici073010.pdf) on the disclosure of derivatives in prospectuses and shareholder reports, the staff made the following comments. The staff observed that both the letter and the following comments were not intended to impose requirements in addition to those in FASB ASC 815, Regulation S-X, or Form N-1A, but rather to enhance transparency of disclosure to shareholders and provide enough information to assist investors in understanding the extent, risks of, and reasons for derivatives use.

- The staff reminded registrants that Form N-1A requires registrants to identify, among other things, how the fund intends to achieve its investment objectives by identifying the fund's principal investment strategies (including the type or types of securities in which the fund invests or will invest principally). The staff also reminded registrants that for non–money market funds, Form N-1A requires MDFP to discuss factors that materially affected the fund's performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the fund's investment adviser.
- Prospectus disclosures should be written in "plain English" and provide meaningful disclosure of the reasons for and intended use of derivatives (for example, hedging, speculation, and substitute for conventional securities) and related risks, as required by Items 4 and 9 of Form N-1A. Prospectus disclosures should also provide enough information so that shareholders can understand the extent to which derivatives are expected to be used. The staff indicated that registrants are not expected to disclose a percentage to convey extent; however, registrants should provide some disclosure of anticipated exposure. Disclosures contained in the prospectus should be tailored to include the derivative types that represent "principal investment strategies of the Fund," with the full list of derivatives which may be used appearing in the statement of additional information. The staff reminded registrants that if a fund changes its investment strategy during the year to invest in derivatives, the fund can "sticker" its prospectus to meet its disclosure obligations of informing shareholders of principal investment strategies. Risk disclosures in the prospectus should provide shareholders with a complete risk profile of the fund's investments taken as a whole and should be adequately tailored based on anticipated derivatives usage as opposed to being a list of risks of all types of derivatives strategies the fund "may" employ. In reviewing prospectuses as part of the derivatives study, the staff compared prospectus disclosures to historical usage as presented in the prior two to three years of financial statements to identify those strategies which appeared to be "principal" strategies as opposed to those which were infrequently employed. The staff observed that in certain cases, many funds in a fund family had the same derivative disclosures in their prospectuses despite significantly differing levels of derivative usage (for example, the same disclosures were made for funds in the fund family which used derivatives extensively and for other funds in the same fund family which did not use derivatives).
- The staff reminded registrants that when they update their registration statements, they should determine whether any prospectus disclosures need to be revised based on derivative usage in the financial statements and anticipated derivatives usage.

- The discussion of derivatives' effect on the fund's performance contained in MDFP should be tailored to the derivatives usage reported in the statement of operations, with adequate discussion of the effect on return (positive or negative), if material. The staff observed in its financial statement reviews that in certain cases MDFP did not discuss the impact of derivatives on performance even when the funds used derivatives as a principal investment strategy and derivatives had a material impact on performance. The staff also observed instances in which derivatives had a material impact on performance but the MDFP contained forward looking disclosure regarding derivative use and did not discuss the impact of derivatives on performance (for example, MDFP indicated the fund may achieve exposures to issuers, interest rates, and currencies through investments in derivatives but did not discuss the impact of derivatives on performance).
- The staff continues to remind registrants that financial statement disclosure required by FASB ASC 815-10-50-1A of how and why funds use derivatives during the reporting period should be tailored to the actual reasons for derivative use, rather than reciting the reasons for why derivatives "may" be used or copying prospectus disclosure. The staff encourages financial statement preparers to discuss the reasons for derivatives use with portfolio managers to enhance the disclosure's relevance. Additionally, the staff observed that footnotes within a fund complex should be tailored to the actual extent of derivatives usage by individual funds, rather than using identical disclosure for all funds regardless of the level of activity.
- Disclosure of the volume of derivatives use, as required by FASB ASC 815-10-50-1A, should be presented in a manner which is meaningful to shareholders. The staff noted that there is flexibility in how to disclose the volume of use and encouraged registrants to leverage other information in the financial statements, where appropriate. It is acceptable, where appropriate, to state in narrative form that the period-end positions reported in the schedule of investments and the realized and unrealized gain or loss from derivatives appearing in the statement of operations are indicative of the volume of derivatives used during the period, to present ranges (minimum and maximum) of use during the year, or to present an average notional volume for the year.
- For disclosure of credit derivatives, the staff observed that in some instances it was difficult to identify whether a registrant had purchased or sold a particular position, with the only distinction apparent from inclusion of the additional disclosure of the current status of the payment or performance risk of the credit derivative required by FASB ASC 815-10-50-4K for written credit derivatives. The staff urged identification between purchased and written derivatives in a manner that is clear to less sophisticated readers. Similarly, when credit derivatives are sold, and the additional FASB ASC 815-10-50-4K disclosure requirement of risk of performance under the contract is expressed by presenting current credit spreads, an explanation should be provided of the relationship between the size of the credit spreads and the likelihood the fund will

have to make payment to the counterparty under the derivative contract to enhance transparency.

- The staff observed that certain funds did not disclose the counterparties to OTC swaps and forwards in the financial statements. The disclosure of counterparties to OTC derivative contracts is, in the staff's view, a material component of the security description as required by Regulation S-X. However, counterparties to exchange-traded derivatives need not be disclosed as, typically, the exchange stands behind the performance obligation under the contract regardless of the executing counterparty.

Changes of Period-Ends; Fund Mergers

.77 Generally, Rule 30e-1 of the 1940 Act, "Reports to Stockholders of Management Companies," requires investment companies to transmit financial statements to shareholders at least semiannually, within 60 days after period-end. The staff has delegated authority to grant extensions to the transmission requirement if the fund can demonstrate "good cause." If an investment company changes its fiscal year-end or semiannual reporting period by one month, the staff may provide no-action relief to allow a 15-day delay in order to issue a single shareholder report containing financial statements with separate columns and separate schedules of investments for the most recent six-month or annual period along with the short one-month "stub" period. For example, if in April an investment company changes its fiscal year-end from July 31 to August 31, the registrant can request relief to issue a single report, containing financial statements for the 12 months ended July 31 and the one-month period ended August 31, within 75 days of July 31. Another example is when an investment company changes its fiscal year-end from January 31 to August 31, in lieu of providing an unaudited semiannual report to shareholders for the six-month period ended July 31, the registrant can request relief to issue a single audited report, containing financial statements for the seven-month period ended August 31, within 75 days of July 31. In both examples, all periods presented must be audited, transmitted to shareholders, and filed on Form N-CSR within 75 days of July 31. A form letter is available from the staff to request the no-action relief containing the applicable conditions; registrants anticipating a one-month change in fund reporting periods are encouraged to contact the staff to obtain the form letter.

.78 The reporting of pro forma financial information in Form N-14 filings for investment company mergers is governed by Article 11 of Regulation S-X. Rule 11-02(b)(1) of Regulation S-X permits a narrative description of the pro forma effects of the transaction in lieu of condensed pro forma financial statements when there are a limited number of pro forma adjustments and those adjustments are easily understood. Narrative descriptions should include significant elements of the transaction, including, but not limited to

1. A general description of the merger, including the identification of the investment company whose financial performance will be carried over to financial statements prepared in future periods;

   Note: For transactions structured as mergers of multiple registered management investment companies, disclosure of whether the mergers are contingent upon the target companies' shareholders approving the merger.

2. Disclosure of the cost of the merger to each of the participating registered management investment companies and rationale for cost allocation, whether or not the merger is consummated;
3. A general description of the tax consequences of the merger, including the capital loss carryforwards available to each investment company and whether those capital loss carryforwards are subject to expiration or limitation;
4. Disclosure of information related to portfolio realignment, if any, that will take place after consummation of the merger, including
    - *a.* the reasons for portfolio realignment,
    - *b.* the extent and cost of portfolio realignment,
    - *c.* the percentage of the target company's portfolio that is expected to be sold as a result of portfolio realignment and an estimate of the related realized gains expected to result from such sales, and
    - *d.* a statement that total merger costs do not reflect commissions that would be incurred during portfolio realignment;
5. Pro forma effects of the transaction (assuming all investment companies subject to merger had merged) on
    - *a.* the significant accounting policies, including valuation policies,
    - *b.* net assets,
    - *c.* management fees and other expenses, and
    - *d.* any other significant adjustments resulting from the transaction; and
6. Reference to the audited financial statements of each investment company participating in the merger

Money Market Funds

.79 The staff has noted inconsistencies in the maturity dates of portfolio securities that are disclosed in money market funds' schedules of investments. The staff has taken the position that when disclosing maturity date required by Article 12-12 of Regulation S-X, at a minimum, money market funds should report the date when the fund is unconditionally permitted to demand repayment (the "demand date"). Reporting the demand date is consistent with the recently adopted weighted average life calculation under Rule 2a-7 of the 1940 Act. In addition to reporting the demand date, money market funds may also report the next interest rate reset date and the legal maturity date. Also, the staff believes this guidance to be appropriate for other types of fixed-income funds (for example, ultra-short bond funds).

.80 The staff has received inquiries from registrants who manage multiclass money market mutual funds. In certain instances, a fund may have realized a loss on a portfolio security which was appropriately allocated among the fund's classes on the realization date. Subsequently, one of the classes had a significant redemption that caused the net asset value per share of that individual class to deviate from a constant $1.00, even though it is immediately evident that the fund as a whole is not impaired (that is, the fund as a whole did not "break the buck"). The staff expressed a view that, in these instances, it is not inconsistent with Rule 18f-3 under the 1940 Act to reallocate the loss

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among classes based on the relative net assets attributable to each class at the current date as long as the following conditions are met: (i) All shareholders subscribe to and redeem from the money market fund at $1 per share; (ii) One class "breaks the buck" due to a large redemption which was processed at $1 per share but the fund's shadow priced *net asset value* (NAV) measured at the fund level does not "break the buck;" (iii) the fund's Board of Directors believes that retroactive reallocation is in the best interests of shareholders, is fair to shareholders, and approves the reallocation in accordance with Rule 18f-3; and (iv) the retroactive reallocation results in an annualized rate of return of each class that differs by class specific expenses.

.81 Finally, the staff reminded registrants that Item 74W of Form N-SAR requires registrants to report the NAV of money market funds based on a "mark-to-market" value (that is, the "shadow price") of the fund at the period-end date, not at the amortized cost value.

SEC Final Rule Developments

Custody of Funds or Securities of Clients by Investment Advisers

.82 In December 2009, the SEC adopted rules designed to substantially increase the protections for investor funds and securities of which an investment adviser registered with the SEC has custody. Depending on the investment adviser's custody arrangement, the rules would require the adviser to be subject to a surprise examination and, in certain cases, custody controls examination that were generally not required under the previous rules. The effective date of the amendment is March 12, 2010, subject to certain exceptions. Readers are encouraged to review the full text of Rule Release No. IA-2968 *Custody of Funds or Securities of Clients by Investment Advisers* and the related Interpretive Release No. IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*. Additionally, both the SEC and the AICPA have released frequently asked questions about the custody rule which can be located at www.sec.gov/divisions/investment/custody_faq_030510.htm and www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/DownloadableDocuments/AICPA_IC_EP_FAQ_custody_rule_August_17.pdf, respectively.

.83 An examination of funds and securities must be conducted pursuant to paragraph (a)(4) of Rule 206(4)-2 under the Investment Advisers Act of 1940. This rule requires that all registered investment advisers (or an investment adviser required to register) who have custody of client funds or securities, as defined, have an independent public accountant conduct an examination on a surprise basis once every calendar year. The rule defines *custody* to mean an investment adviser, or its related person, holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes:

- possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the investment adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them;

- any arrangement (including a general power of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian; and
- any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the investment adviser or their supervised person legal ownership of or access to client funds or securities.

.84 An adviser that has the authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians, if the client has authorized the investment adviser in writing to make such transfers and a copy of that client specific authorization is provided to the qualified custodian, is not deemed to have custody. An investment adviser is deemed to have custody if it has an identification number and password providing it with the ability to withdraw funds or securities or transfer them to an account not in the client's name at a qualified custodian. Additionally, *related person* is defined in the rule as any person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser. Legal assistance may be required for determining whether an investment adviser is deemed to have custody.

.85 The independent public accountant must file a certificate on Form ADV-E with the SEC within 120 days of the time chosen by the independent public accountant, stating that it has examined the funds and securities and describing the nature and extent of the examination. Rule 206(4)-2(a)(4)(ii) under the Investment Advisers Act of 1940 states that the independent accountant, upon finding any material discrepancies during the course of the examination, should notify the SEC within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first-class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations. This surprise examination and report follow the provisions of AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1). AT section 601 enables true direct reporting on the subject matter. The rule also requires that a qualified custodian maintain client funds and securities in a separate account for each client under that client's name or in accounts that contain only the clients' funds and securities, under the adviser's name as agent or trustee for the clients. Clients must be notified promptly in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, when an account is opened by an investment adviser on a client's behalf and following any changes to this information. The investment adviser must also have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of the investment advisers' clients for which it maintains funds or securities. Rule 206(4)-2(b) lists the exceptions to these requirements for shares of mutual funds, certain privately offered securities, fee deductions, limited partnerships subject to annual audit, registered investment companies, and certain related persons.

.86 The surprise examination must commence on or before December 31, 2010, but does not need to be completed until 120 days after the time chosen by the accountant performing the surprise examination. If the investment adviser maintains client assets as qualified custodian (as discussed subsequently), the first surprise examination must commence no later than six months after obtaining the internal control report. For an adviser that became subject to the rule after the effective date, the surprise examination must commence within six months after it became subject to the rule.

.87 Advisers to pooled investment vehicles may be deemed to comply with the surprise examination requirements of the rule by obtaining an audit of the pool and delivering the audited financial statements to pool investors within 120 days of the pool's fiscal year-end; for funds of funds, the financial statements must be distributed within 180 days. The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB. If the accountant was not currently subject to inspection by the PCAOB, the investment adviser will still qualify for the exemption if the accountant becomes subject to regular inspection by the PCAOB before the issuance of the audited financial statements for the pooled investment vehicle's 2010 fiscal year. Lastly, the advisers to pools complying with the rule by distributing audited financial statements to investors must obtain an audit upon liquidation of the pool when the liquidation occurs prior to the pool's fiscal year-end. If the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule. For a pool that is not relying on the audit provision to satisfy the custody rule, the rule requires privately offered securities held by the pool to be placed with a qualified custodian (as defined subsequently); it also requires that the accounting firm performing the surprise examination to verify these privately offered securities, along with other funds and securities.

.88 If the investment adviser, or its related person, maintains client funds or securities as a qualified custodian in connection with advisory services provided to clients, additional requirements exist in accordance with Rule 206(4)-2(a)(6). A *qualified custodian* is defined by the rule as (*a*) a *bank* as defined in Section 202(a)(2) of the Investment Advisers Act of 1940 or a *savings association* as defined in Section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the FDIC under the Federal Deposit Insurance Act; (*b*) a broker-dealer, registered under Section 15(b)(1) of the Securities Exchange Act of 1934, holding the client assets in customer accounts; (*c*) a futures commission merchant (FCM), registered under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts but only with respect to clients' funds and security futures or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (*d*) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. Therefore, custody does not equate to serving as a qualified custodian under the rule.

.89 When the investment adviser, or its related person, maintains the client funds and securities as a qualified custodian in connection with advisory services provided to clients, the independent public accountant engaged to perform the surprise examination must be registered with, and subject to regular inspection by, the PCAOB.

.90 An investment adviser that is a qualified custodian must at least once each calendar year obtain or receive from its related person a written internal control report related to its or its affiliates' custodial services, including the safeguarding of funds and securities, that includes an opinion from an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB. The compliance date for obtaining an internal control report is September 12, 2010. Advisers that are newly subject to Rule 206(4)-2(a)(6) must obtain the internal control report within six months of becoming subject to the requirement. Regardless of whether an adviser to a pooled investment vehicle obtains a surprise examination or satisfies that requirement by obtaining an audit and distributing the audited financial statements to pool investors within 120 days of the end of the pooled investment vehicle's fiscal year (or 180 days for funds of funds), if the pooled investment vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser, the adviser to the pool would have to obtain, or receive from the related person, an internal control report. This requirement could be satisfied with a type 2 service auditor's report under Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), or an examination report on internal control over compliance conducted in accordance with AT section 601. As explained in question XIII.3 of the SEC's "Staff Responses to Questions About the Custody Rule," in addition to the two types of reports mentioned previously and Release IA-2969, all of which that satisfy the requirements for an internal control report, a report under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1) would also be acceptable. As discussed in the "Service Organizations" section of this alert, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801) will replace the guidance previously found in SAS No. 70. Therefore, this type of report would also satisfy the internal control requirement. This internal control report must include an opinion concerning whether controls have been placed in operation as of a specific date and are suitably designed and operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the investment adviser or its related person on behalf of the advisory clients during the year. The internal control report does not need to address the effectiveness of controls over custodial services prior to March 12, 2010 (the effective date of the amended rule), even if it results in a shortened examination period for the 2010 report. Further, a qualified custodian that obtained a custody-related SAS No. 70 report in 2009 is not expected to alter its reporting cycle in 2010.

.91 The accountant must also verify that the funds and securities are reconciled to a custodian other than the investment adviser or its related person (for example, the Depository Trust Corporation). The accountant's tests of the custodian's reconciliation should include either direct confirmation, on a test basis, with unaffiliated custodians or other procedures designed to verify that the data used in the reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered.

.92 An independent accountant's illustrative report on examinations of securities pursuant to Rule 206(4)-2 of the Investment Advisers Act of 1940 and management's assertion can be found in the 2010 edition of the Audit and Accounting Guide *Investment Companies* as well as on the Investment Companies Expert Panel page on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/Pages/InvestmentCompanies.aspx. An illustrative report, developed under AT section 101, of an independent registered public accounting firm on management's assertion regarding controls at a custodian pursuant to Rule 206(4)-2 and Release No. IA-2969 under the Investment Advisers Act of 1940 can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/DownloadableDocuments/Custody_report_September_1final.pdf. Lastly, the SEC staff has prepared *Custody of Funds or Securities of Clients by Investment Advisers: A Small Entity Compliance Guide*, which can be accessed at http://sec.gov/info/smallbus/secg/custody_rule-secg.htm.

Money Market Fund Reform

.93 In February 2010, the SEC issued Release No. IC-29132, *Money Market Fund Reform*, which is designed to make money market funds more resilient to certain short-term market risks and to provide greater protections for investors in a money market fund that is unable to maintain a stable NAV per share. These amendments were issued in response to the substantial losses incurred by money market funds during the economic crisis, including the first time a significant money market fund "broke the buck." As an immediate response, the U.S. Department of Treasury and the Federal Reserve intervened with the Temporary Guarantee Program for Money Market Funds and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, both of which have since expired. The amendments will tighten the risk-limiting conditions of Rule 2a-7 of the 1940 Act by, among other things,

- requiring money market funds to maintain a portion of their portfolios in instruments that can be readily converted to cash, reducing the maximum weighted average maturity of portfolio holdings, and improving the credit quality of portfolio securities
- requiring money market funds to maintain liquidity buffers that will help them withstand sudden demands for redemptions
- requiring money market funds to report their portfolio holdings monthly to the SEC
- requiring fund managers to stress test their portfolios against potential economic shocks such as sudden increases in interest rates, heavy redemptions, and potential defaults
- permitting a money market fund that has "broken the buck" (that is, repriced its securities below $1.00 per share), or is at imminent risk of breaking the buck, to suspend redemptions to allow for the orderly liquidation of fund assets

.94 The basic premise underlying money market funds' use of the amortized cost method of valuation is that the high-quality, short-term debt securities these funds typically hold until maturity will eventually return to their amortized cost value, regardless of any current disparity between the amortized cost value and market value, and, moreover, that they would not ordinarily be expected to fluctuate significantly in value. Money market funds are permitted to continue valuing their portfolio securities at amortized cost as long as the deviation between the portfolio's amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current market-based NAV per share of the fund. To reduce the likelihood of a material deviation, the rules' risk-limiting conditions are intended to limit the fund's exposure to certain risks, such as credit, and interest rate risks. The rule also contains certain procedural requirements overseen by the fund's board of directors. For example, the fund must periodically compare the amortized cost NAV of the fund's portfolio against the mark-to-market NAV of the portfolio (its so-called shadow price). If a difference of more than one half of 1 percent (or $0.005 per share) occurs, the board must consider promptly what action, if any, should be taken.

.95 Many of these amendments became effective May 5, 2010. Readers are encouraged to review the full release, including the complete discussion of compliance dates in Section III. The staff of the Division of Investment Management has prepared some responses to questions about money market fund reform, which can be accessed at www.sec.gov/divisions/investment/guidance/mmfreform-imqa.htm.

Proxy Disclosure Enhancements

.96 Release No. IC-29092, *Proxy Disclosure Enhancements*, was issued by the SEC in December 2009 to enhance information provided in connection with proxy and information statements, annual reports and registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933 as well as the 1940 Act. This rule became effective on February 28, 2010. Management investment companies registered under the 1940 Act will now be required to have expanded disclosure regarding director and nominee qualifications; past directorships held by directors and nominees; legal proceedings involving directors, nominees, and executive officers to funds; and new disclosure about leadership structure and the board's role in the oversight of risk. These new disclosure requirements are in response to investors' increased interest in corporate accountability and will better enable shareholders to evaluate the leadership of public entities.

.97 This rule amends Schedule 14A and Forms N-1A, N-2, and N-3 for funds. If an existing fund's fiscal year ends on or after December 20, 2009, any proxy statement must be in compliance with the new proxy disclosure requirements if filed on or after February 28, 2010. If an existing fund has multiple series, and the fiscal year of any series ends on or after December 20, 2009, any posteffective amendment to the fund's existing registration statement must comply with the form amendments if the amendment is filed on or after February 28, 2010, and the amendment is filed to make changes that affect a series with a fiscal year that ends on or after December 20, 2009. The SEC has created two documents, "FAQs About Proxy Disclosure Enhancements Transition for Registered Investment Companies" and "Proxy Disclosure Enhancements Transition," both of which can be accessed at the SEC's website, www.sec.gov.

Internet Availability of Proxy Materials

.98 In February 2010, Release No. IC-29131, *Amendments to Rules Requiring Internet Availability of Proxy Materials*, was released with the intent to clarify and provide additional flexibility regarding the format of the "Notice of Internet Availability of Proxy Materials" to better communicate with shareholders. Explanatory materials regarding the reasons for the use of the notice and access to proxy rules and the process of receiving and reviewing proxy materials and voting pursuant to the notice and access proxy rules will be included.

.99 In 2007, the SEC established procedures that promote the use of the Internet as a reliable and cost-efficient means of making proxy materials available to shareholders. Issuers and other soliciting persons have an option to either send a full set of proxy materials to all shareholders or send shareholders only the notice. Many issuers have chosen to use the notice-only option because of its substantial cost savings. However, statistics indicate lower shareholder response rates to proxy solicitations when the notice-only option is used. These amendments will provide additional flexibility to provide to shareholders a more effective explanation of the importance and effect of the notice and the reasons for its use, which should better facilitate use of the SEC's rules and improve investor understanding.

.100 Prior to these amendments, a registered investment company was permitted to accompany the notice with a prospectus or report to shareholders. Consistent with permitting mutual funds to use a summary prospectus to satisfy their delivery obligations, the rules have been revised to permit mutual funds to accompany the notice with a summary prospectus. These amendments became effective on March 29, 2010.

SEC Proposed Rule Developments

Distribution Fees and Confirmations

.101 The SEC's proposed rule Release No. IC-29367, *Mutual Fund Distribution Fees; Confirmations*, was issued during July 2010 and would replace Rule 12b-1 under the 1940 Act with Rule 12b-2. Historically, Rule 12b-1 has permitted registered open-end management investment companies to use fund assets to pay for the cost of promoting sales of fund shares. Funds would continue to be allowed to bear promotional costs within certain limits. The proposed framework would:

- continue to allow funds to give investors choices regarding how and when to pay for sales charges
- improve disclosure designed to enhance investor understanding of those charges
- limit the cumulative sales charges each investor pays (no matter how they are imposed)
- eliminate uncertainties associated with current requirements while providing a more appropriate role for fund directors

.102 The proposal also includes requirements for clearer disclosures about all sales charges in fund prospectuses, annual and semiannual reports to shareholders, and investor confirmation statements. Funds and their underwriters would have the option of offering classes of shares that could be sold by dealers with sales charges set at competitively established rates—rates that could better reflect the services offered by the particular intermediary and the value investors place on those services. For funds electing this option, the amendments would provide relief from restrictions currently in place that limit retail price competition for distribution services.

.103 In 2009, funds collected $9.5 billion in Rule 12b-1 fees. Currently, sales charge arrangements are disclosed in fund prospectuses and are governed by statutory provisions and rules adopted by the SEC and FINRA. Rule 12b-1 requires that, before using fund assets to pay for distribution expenses, a fund must adopt a written plan (a "Rule 12b-1 plan") describing all material aspects of the proposed financing of distribution, which must contain provisions similar to several of those the 1940 Act requires for advisory contracts between the fund and its investment adviser. The Rule 12b-1 plan must be approved initially by the fund's board of directors as a whole and then separately by the "independent" directors. The rule does not restrict the amounts of the fees that may be approved under the plan; however, rules adopted by FINRA effectively set the maximum Rule 12b-1 fees by prohibiting broker-dealers from selling funds that pay more than 25 basis points per year of fund assets as "service fees" and more than 75 basis points per year of fund assets as asset-based sales charges. The rule requires directors (including a majority of the independent directors) to conclude, in exercising their reasonable business judgment and in light of their fiduciary duties, that a reasonable likelihood exists that the plan will benefit both the fund and its shareholders.

.104 Many of the assumptions used in the adoption of Rule 12b-1 appear to no longer reflect current marketplace realities, including the role that these fees play in the distribution of fund shares and the tasks that directors should be required to undertake in considering whether to approve Rule 12b-1 fees. Further, many investors are unsure of the role and importance of Rule 12b-1 fees. This led to the rescission of Rule 12b-1 in its entirety, as proposed by this rule (as opposed to amending it).

.105 The new approach outlined in proposed Rule 12b-2, differentiates between the two constituent parts of existing Rule 12b-1 fees (asset-based sales charges and service fees). Funds would be able to use a limited amount of fund assets to pay for any distribution related expenses, but the maximum amount would be tied to the service fee limit imposed by the FINRA sales charge rule (currently 25 basis points per year). By amending Rule 6c-10, funds would also be permitted to deduct from fund assets amounts in excess of the marketing and service fee. This would be called an "ongoing sales charge," and these charges would be treated as another form of sales load.

.106 Limits on asset-based sales charges would also be imposed by referencing the front-end load imposed by the fund or, if none, by referencing the aggregate sales load cap imposed under the FINRA sales charge rules for funds with an asset-based sales charge and service fee (currently 6.25 percent). These limits would be based on the cumulative amounts of sales charges that an investor pays in any form (front-end, deferred, or asset-based). A fund that imposes an ongoing sales charge must automatically convert fund shares to a class of shares without an ongoing sales charge no later than when the investor has paid cumulative charges that approximate the amount the investor otherwise would have paid through a traditional front-end load (or, if none, the 6.25 percent cap). The new rule would shift the focus of the limits from how much fund underwriters may collect in asset-based sales charges (a fund-level cap) to how much individual shareholders will pay either directly or indirectly (a shareholder account-level cap).

.107 Another amendment to Rule 6c-10 would permit an alternative, elective distribution model. In this new model, intermediaries of a fund could impose charges for sales of the fund's shares at negotiated rates, much like they charge commissions on sales of ETFs and other equity securities. The proposed rule would permit fund intermediaries to charge sales loads other than those established by the fund underwriter and disclosed in the fund prospectus.

.108 Under the proposal, funds would be required to comply with the amendments for all shares issued after the compliance date of the new rules. However, a five-year grandfathering period would exist after the compliance date for share classes issued prior to the compliance date and would deduct fees pursuant to the existing Rule 12b-1, after which those shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge. The full text of the proposed rule can be accessed at the SEC's website, www.sec.gov. Comments on these amendments are due by November 5, 2010.

Target Date Retirement Fund Names and Marketing

.109 The SEC issued a rule proposal in June 2010 to help clarify the meaning of a date in a target date fund's name, enhance the information provided to investors in these funds as they invest for retirement, and reduce the potential for investors to be confused or misled regarding these and other investment companies. Concerns about target date retirement funds were brought about from market losses incurred during the recent financial crisis and the increasing significance of target date funds in 401(k) plans. Specific concerns have also been raised regarding the naming of these funds and their marketing.

.110 The rule amendments would:

- require a target date retirement fund that includes the target date in its name to disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in marketing materials
- require marketing materials for target date retirement funds to include a table, chart, or graph depicting the fund's asset allocation over time, together with a statement that would highlight the fund's final asset allocation
- require a statement in marketing materials to the effect that a target date retirement fund should not be selected based solely on age or retirement date and is not a guaranteed investment; additionally, the stated asset allocations may be subject to change
- provide additional guidance regarding statements in marketing materials for target date retirement funds and other investment companies that could be misleading

.111 Comments on this proposal were due in August 2010. To further explain target date funds, the SEC also issued an Investor Bulletin jointly with the Department of Labor. Both documents can be accessed at the SEC's website, www.sec.gov.

CFTC Developments

Commodities

.112 Global futures and options contract volume increased comparing the first six months of 2010 to the same period in 2009. In the first six months of 2010, volume on U.S. futures exchanges was 3.6 billion contracts, a 16 percent increase from the same period in 2009. Volume traded on foreign exchanges amounted to 7.6 billion contracts in the first six months of 2010. Trading volume in interest rate and equity products continued to account for more than half of worldwide trading volume.

.113 The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers decreased by $8 billion from approximately $175 billion as of June 30, 2009, to approximately $167 billion as of June 30, 2010.

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Off-Exchange Retail Foreign Currency Transactions

.114 The CFTC issued final regulations concerning off-exchange retail foreign currency transactions effective October 18, 2010. The rules implement provisions of the Dodd-Frank Act and the Food, Conservation, and Energy Act of 2008, which, together, provide the CFTC with broad authority to register and regulate entities wishing to serve as counterparties to, or to intermediate, retail foreign exchange (forex) transactions.

.115 The final forex rules put in place requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital, and other business conduct and operational standards. Specifically, the regulations require:

- counterparties offering retail foreign currency contracts as either FCMs or retail foreign exchange dealers (RFEDs), a new category of registrant, to be registered.
- persons who solicit orders, exercise discretionary trading authority, or operate pools with respect to retail forex also will be required to register, either as introducing brokers, commodity trading advisers, commodity pool operators (as appropriate), or as associated persons of such entities to be registered.
- "otherwise regulated" entities, such as U.S. financial institutions and SEC-registered brokers or dealers, remain able to serve as counterparties in such transactions under the oversight of their primary regulators.
- FCMs and RFEDs to maintain net capital of $20 million, plus 5 percent of the amount, if any, by which liabilities to retail forex customers exceed $10 million.
- leverage in retail forex customer accounts will be subject to a security deposit requirement to be set by the NFA within limits provided by the CFTC.
- all retail forex counterparties and intermediaries will be required to distribute forex-specific risk disclosure statements to customers and comply with comprehensive recordkeeping and reporting requirements.

.116 The final rule may be found in the Federal Register at www.federalregister.gov/articles/2010/09/10/2010-21729/regulation-of-offexchange-retail-foreign-exchange-transactions-and-intermediaries#p-3.

Minimum Adjusted Net Capital Requirements of FCMs and Introducing Brokers

.117 Effective as of March 31, 2010, the CFTC revised financial requirements for FCMs and introducing brokers (IBs). The revised requirements affect FCM financial requirements by

- increasing the minimum dollar capital requirement to $1,000,000;
- increasing the risk-based capital requirement for noncustomer accounts from 4 percent to 8 percent of the total risk margin requirement for positions carried in noncustomer accounts; and
- including cleared OTC derivative positions in an FCM's risk-based capital calculation for customer and noncustomer accounts.

.118 The CFTC also revised the financial requirements for IBs by increasing the net capital requirement from $30,000 to $45,000. The CFTC's increase to the IB minimum capital requirement brings it to the same level currently required under NFA Financial Requirements Section 5, "Introducing Broker Financial Requirements." The final rule may be found at www.cftc.gov/LawRegulation/FederalRegister/FinalRules/e9-31058.html.

Exemption From Certain CFTC Regulations

.119 In May 2010, the CFTC published an informational and guidance document regarding the application procedure pursuant to CFTC Regulation 30.10, which generally provides that persons located and doing business outside the United States and who are subject to a comparable regulatory framework in the country in which they are located may qualify for an exemption from the application of certain CFTC regulations, including relief from registration as an FCM. For more information, please refer to the Foreign Markets, Products, & Intermediaries subheading under the "International" tab of www.cftc.gov (or directly at www.cftc.gov/International/ForeignMarketsandProducts/index.htm). Appendix A to Part 30 of the CFTC's Regulations generally outlines the procedure for a foreign regulator or self-regulatory organization seeking to obtain relief on behalf of a foreign broker subject to its oversight. As the operating division responsible for evaluating applications pursuant to Regulation 30.10, the Division of Clearing and Intermediary Oversight (DCIO) prepared and published a more detailed description of the information set forth in appendix A. In particular, the guidance is intended to streamline the application process by informing prospective Regulation 30.10 applicants of the information generally requested by DCIO when evaluating applications for Regulation 30.10 relief.

Commodity Pool Operator Reporting

.120 The CFTC amended its regulations governing the periodic account statements that commodity pool operators (CPOs) are required to provide to commodity pool participants and, effective for 2009, the annual financial reports that CPOs are required to provide to commodity pool participants and file with the NFA. The amendments became effective December 9, 2009, and changes that affect annual reporting requirements were applicable to commodity pool annual reports for fiscal years ending December 31, 2009, and later. The amendments

- specify detailed information that must be included in the periodic account statements and annual reports for certain commodity pools with more than one series or class of ownership interest;
- clarify that the periodic account statements must disclose either the NAV per outstanding participation unit in the pool, or the total value of a participant's interest or share in the pool;
- extend the time period for filing and distributing annual reports of commodity pools that invest in other funds;
- codify existing CFTC staff interpretations regarding the proper accounting treatment and financial statement presentation of certain income and expense items in the periodic account statements and annual reports;
- streamline the final reporting requirements for pools ceasing operation;

- establish conditions for use of International Financial Reporting Standards (IFRS) in lieu of U.S. generally accepted accounting principles (GAAP) and a notice procedure for CPOs to claim such relief; and
- clarify and update several other requirements for periodic and annual reports prepared and distributed by CPOs.

CFTC Annual "Dear CPO" Letter

.121 On January 21, 2010, CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The CFTC anticipates issuing a similar letter in January 2011. The letter emphasizes the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff also suggests that CPOs share the letter with their independent auditors. Major concerns addressed in the letter include the following:

- Filing procedures and due dates of commodity pool financial filings
- Master-feeder and fund of funds
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- CPOs claiming exemption under Regulation 4.13
- Reports of liquidating pools
- Reports of series funds structured with a limitation on liability among the different series
- Accounting developments
    - — FASB ASC
    - — Disclosures about derivative instruments
    - — AICPA Commodities Audit Practice Aid
    - — AICPA Audit Risk Alerts
    - — FASB ASC 820
    - — AICPA Practice Aid *Alternative Investments—Audit Considerations*
    - — AICPA Technical Guidance, specifically Technical Questions and Answers (TIS) section 6910.23, "Accounting Treatment of Offering Costs Incurred by Investment Partnerships" (AICPA, *Technical Practice Aids*)

.122 The clearing and intermediary oversight division has issued similar letters in prior years, which are available at the CFTC's website. Prior letters from 1998 forward are available at the CFTC's website at www.cftc.gov/IndustryOversight/Intermediaries/CPOs/guidancecporeports.html. Those letters should be consulted with respect to commodity pool annual financial statements and reporting. Readers are encouraged to view the full text of this letter at www.cftc.gov/ucm/groups/public/@iointermediaries/documents/file/cpoannualguidanceletter2009.pdf and to monitor the CFTC website for the most recent guidance.

.123 Auditors may also consider additional CFTC guidance related to auditing regulatory supplementary schedules, maintaining minimum financial requirements and notification requirements, segregation of customer funds in multiple currencies, and forex transactions. Readers may refer to the CFTC website for additional details.

National Futures Association

Commodity Pools

.124 NFA adopted compliance rules applicable to CPOs as follows:

- Rule 2-45, "Prohibition of Loans by Commodity Pools to CPOs and Related Entities," prohibits a CPO from permitting a commodity pool to use any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity.
- Rule 2-46, "CPO Quarterly Reporting Requirements," effective for the quarter ended March 31, 2010, requires each CPO member to file certain information on a quarterly basis to NFA, using NFA's EasyFile System, for each pool it operates that has a reporting requirement under CFTC Regulation 4.22 (which includes exempt pools under CFTC Regulation 4.7). Within 45 days after the end of each quarterly reporting period, CPOs must report:
    - — the identity of the pool's administrator, carry broker(s), trading manager(s) and custodian(s);
    - — a statement of changes in NAV for the quarterly reporting period;
    - — the monthly performance for the three months comprising the quarterly reporting period; and
    - — a schedule of investments identifying any investment that exceeds 10 percent of the pool's NAV at the end of the quarterly reporting period.

Foreign Currency Exchange Transactions

.125 Effective October 1, 2010, the NFA amended its Financial Requirements Section 11(b) and (c) and its related Interpretive Notice 9053, *Forex Transactions* (www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9053&Section=9), to remove regulated foreign equivalents from kinds of entities considered suitable locations for assets to be considered current for purposes of determining a forex dealer member's (FDM's) adjusted net capital or to cover its currency positions. Therefore, FDMs will no longer be able to treat assets held at regulated foreign equivalents of such exempt entities as current.

.126 Notwithstanding this, the amendments will continue to permit NFA to approve the use of certain foreign equivalent entities that are appropriately regulated and capitalized. Section (C)(3) of Interpretive Notice 9053 lists the factors NFA considers when determining whether to approve an otherwise unregulated entity for purposes of Financial Requirements Section 11(b) and (c).

Global Investment Performance Standards

.127 Although compliance with the Global Investment Performance (GIPS) standards is voluntary, an investment management firm's claim of compliance with the performance standards is widely regarded as providing a competitive advantage. The performance standards include both required and recommended guidelines for calculating and reporting performance. The performance standards recommend that firms obtain independent third-party verification of a firm's claim of compliance with the performance standards. Statement of Position 06-1, *Reporting Pursuant to the Global Investment Performance Standards* (AICPA, *Technical Practice Aids*, AUD sec. 14,420) provides guidance to practitioners for engagements to examine and report on aspects of a firm's compliance with the GIPS standards (a verification engagement) and for engagements to examine and report on the performance presentation of specific composites (a performance examination). Such examination engagements should be performed pursuant to AT section 101.

.128 In January 2010, the CFA Institute released revised GIPS standards. The significant changes to the GIPS standards include the requirement of assets to be valued using a fair value methodology when no market value is available, the requirement to present the standard deviation (widely accepted as a common measure of portfolio risk) of the monthly returns of both the composite and the benchmark, the requirement for the firms to disclose their verification status (that is, whether they have been verified), and required prescribed language describing what is and is not covered by verification. The effective date for the 2010 edition of the GIPS standards is January 1, 2011. Compliant presentations that include performance for periods that begin on or after that date must be prepared in accordance with the 2010 edition of the GIPS standards. Early adoption is recommended. See www.gipsstandards.org/ for more information.

PCAOB Constitutionality

.129 On June 28, 2010, the Supreme Court ruled in a lawsuit challenging the constitutionality of the PCAOB. When the PCAOB was set up under SOX, its board members were appointed by the SEC and could be removed only for cause. The Supreme Court ruled, in a 5-4 vote, that although the manner in which the PCAOB was constituted was constitutionally invalid, SOX itself was not invalidated. Rather, the Supreme Court severed from the rest of SOX the provisions relating to the removal of PCAOB board members. The consequence of the Supreme Court's decision is that PCAOB board members will now be removable by the SEC at will, instead of only for good cause. Essentially, this decision has no material impact on the workings of the PCAOB, and all PCAOB programs will continue to operate as usual, including registration, enforcement, and standard-setting activities.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.130 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients. Some risks that may affect an entity in the current economic environment are as follows:

- Marginally achieving explicitly stated strategic objectives
- Volatile real estate and business markets
- Significant measurement uncertainty, including accounting estimates and fair value measurements

- Potentially erroneous or fraudulent activity due to decreased staffing and resurgence of business activity
- The continuing evolution of the postrecessionary marketplace

.131 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.132 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

PCAOB Observations Related to Audit Risk Areas Affected by the Economic Crisis

.133 In September 2010, the PCAOB released *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*. This report was issued to discuss the audit risks and challenges that resulted from the economic crisis that the PCAOB identified through its inspection program. This report covers inspections from the 2007, 2008, and 2009 inspection cycles, which generally involved reviews of audits of issuers' fiscal years ending from 2006–2008. One of the heightened risk factors identified by the PCAOB that is of particular importance to investment companies is in the audit area of fair value measurements. The economic crisis increased uncertainty around fair value measurements, which significantly increased audit risk. Failing to properly test issuers' fair value measurements and disclosures may lead to the auditor not detecting a material misstatement in issuers' financial statements, which may cause investors to be misled.

.134 The following is a summary of the PCAOB observations that investment companies may find pertinent. Firms sometimes planned to test issuers' estimates of fair value of financial instruments by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. Deficiencies observed by inspectors included firms' failures to

- evaluate, or evaluate sufficiently, whether fair value measurements were determined using appropriate valuation methods. In some cases when the issuer used an external valuation, the firms failed to obtain a sufficient understanding of the valuation methods used by these third parties.
- test, or adequately test, controls over issuers' valuation processes. In some cases, by failing to test, or test sufficiently, the operating effectiveness of internal controls over various aspects of issuers' valuation processes, the firms did not have adequate support for the degree of reliance placed on these controls.

- evaluate or evaluate sufficiently, the reasonableness of management's significant assumptions. Examples of this include not performing tests beyond inquiries of management; not appropriately evaluating the reasonableness of assumptions such as discount rates, credit loss expectations, and prepayment assumptions; and not involving a valuation specialist when appropriate.
- evaluate available evidence that was inconsistent with issuers' fair value estimates.

.135 Alternatively, some firms evaluated issuers' estimates of fair value of financial instruments by developing an independent expectation of fair value. Firms often used external pricing services or external valuation specialists to make this evaluation. Deficiencies of the firms observed in this situation included failing to understand the methods or assumptions used by these external parties and failing to evaluate significant differences between the independent estimates used or developed by firms and the fair values recorded by issuers.

.136 Further, firms sometimes failed to test, or test sufficiently, significant, difficult-to-value securities (for example, limiting their testing to inquiries of issuer personnel). Firms also failed to perform sufficient procedures in light of the volatile market conditions, to provide a reasonable basis for extending to year end the conclusions regarding the valuation of investment securities that were reached at an interim date. There were also instances in which firms failed to perform sufficient tests to determine whether issuers' fair value disclosures were in conformity with the requirements of FASB ASC 820.

.137 The report also discusses deficiencies observed in other audit areas affected by the economic crisis. The observations from this report will serve to inform future PCAOB actions in connection with certain inspection, enforcement, and standard-setting activities, and consideration will be given regarding whether additional guidance is needed relating to existing standards. The report can be accessed at http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf.

PCAOB Auditing Standards on Risk Assessment

.138 In August 2010, the PCAOB adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit. These standards were initially proposed in late 2008 and reproposed in late 2009. These risk assessment standards will benefit investors by setting forth requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. They apply to audit procedures spanning from the initial planning stages of the audit to the evaluation of the audit results. Improvements in the risk assessment standards should enhance integration of the audit of financial statements with the audit of internal control over financial reporting by articulating a process for identifying and assessing risks of material misstatements that apply to both portions of the integrated audit.

.139 The new auditing standards, with a brief description of each, are as follows:

- Auditing Standard No. 8, *Audit Risk*, discusses the auditor's consideration of audit risk in both an integrated audit and an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing it to an appropriately low level.

- Auditing Standard No. 9, *Audit Planning*, establishes requirements for planning an audit, such as assessing important matters and establishing an appropriate audit strategy.
- Auditing Standard No. 10, *Supervision of the Audit Engagement*, applies to the engagement partner and other team members who supervise during the audit. It sets forth requirements for supervision of the audit engagement and the work of other engagement members. Related to this topic, the PCAOB also recently issued a release discussing the SOX provision that authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons.
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements for auditors in identifying and assessing risks of material misstatement, including information-gathering procedures.
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements for responding to those identified risks of material misstatement through general audit procedures. It also includes audit procedures related to significant accounts and disclosures.
- Auditing Standard No. 14, *Evaluating Audit Results*, establishes requirements for evaluating audit results and the sufficiency of appropriate audit evidence.
- Auditing Standard No. 15, *Audit Evidence*, discusses what constitutes audit evidence and how to design and perform audit procedures to support the opinion expressed in the auditor's report.

.140 These risk assessment standards will supersede the following six PCAOB interim standards and related amendments: AU-P section 311, *Planning and Supervision*;[1] AU-P section 312, *Audit Risk and Materiality in Conducting an Audit*; AU-P section 313, *Substantive Tests Prior to the Balance Sheet Date*; AU-P section 319, *Consideration of Internal Control in a Financial Statement Audit*; AU-P section 326, *Evidential Matter*; and AU-P section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Standards). The standards, if approved by the SEC, will be effective for audits of fiscal periods beginning on or after December 15, 2010.

.141 In September 2010, the SEC published *Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and*

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[1] The Public Company Auditing Oversight Board (PCAOB) auditing standards and interim standards have been codified into a single "PCAOB Standards and Related Rules" section within the AICPA's Online Professional Library. The section indicators have been changed to more clearly differentiate them from the AICPA standards. For example, PCAOB AU section XXX is now AU-P section XXX.

Response to Risk and Related Amendments to PCAOB Standards to solicit comments on the proposed rules. This notice was posted in the *Federal Register* on September 27, 2010. Comments were due 21 days from the publication of the notice in the *Federal Register*, and the SEC will take action on the proposed rules 90 days from the publication of the notice in the *Federal Register*.

PCAOB Auditing Standard No. 7

.142 In January 2010, the PCAOB announced that the SEC had approved Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 162), which was adopted by the PCAOB in July 2009. Auditing Standard No. 7 (AU-P sec. 162) provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. Auditing Standard No. 7 (AU-P sec. 162) is expected to increase the likelihood that a registered public accounting firm will catch any significant deficiencies before it issues its audit report. As a result, more work may be necessary under this standard than performed under the existing requirements for concurring partners. However, Auditing Standard No. 7 (AU-P sec. 162) explains that the procedures required by the engagement quality reviewer are different in nature than those required to be performed by the engagement team. Further, if the engagement quality reviewer deems more work is required before giving approval of issuance, the engagement team is responsible for completing that work.

.143 This standard applies to all audit engagements, and engagements to review interim financial information, conducted pursuant to the standards of the PCAOB, and it supersedes the PCAOB's interim concurring partner review requirement. Auditing Standard No. 7 (AU-P sec. 162) is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009. For a public, calendar-year company, this standard is applicable for the quarter ended March 31, 2010. Subsequent to the issuance of Auditing Standard No. 7 (AU-P sec. 162), the PCAOB issued Staff Question and Answer *Auditing Standard No. 7*, Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10), to provide further implementation guidance on the documentation requirements of the standard. For the full text of the standard and the question and answer, readers are encouraged to visit the PCAOB's website at www.pcaob.org.

PCAOB Practice Alert on Using the Work of Others

.144 In July 2010, the PCAOB issued Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06), because it observed that a number of registered public accounting firms located in the United States have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the United States. This practice alert contains reminders for registered firms of their obligations when using the work of other firms or using assistants engaged from outside the firm, such as in the aforementioned situation. It also describes the circumstances under which the firm issuing the audit report may use the work and reports of another auditor.

.145 Auditors who engage assistants from outside their firm are governed by the same standards regarding planning the audit and supervising assistants when audit work is performed by assistants employed by the auditor's firm. Observations from the PCAOB's inspection process suggest that some firms may be issuing audit reports based on the work of another firm, or using the work of assistants engaged from outside the firm, without complying with the relevant PCAOB standards. The practice alert is broken down into two sections:

- Using the work of other auditors. This discussion is based upon AU-P section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *PCAOB Standards and Related Rules*, Standards).
- Engaging assistants from outside the firm. This discussion is based upon numerous sections of auditing guidance.

.146 The full text of this practice alert can be found at http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf.

PCAOB Practice Alert on Significant Unusual Transactions

.147 In April 2010, the PCAOB issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05), which is intended to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions. Staff Audit Practice Alert No. 5 compiles existing requirements from PCAOB standards and groups them into the following categories: identifying and assessing risks of material misstatement, responding to risks of material misstatement, consulting others, evaluating financial statement presentation and disclosure, communicating with audit committees, and reviewing interim financial information. Staff Audit Practice Alert No. 5 can be accessed at http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.

Supplementary and Other Information Related to Financial Statements

.148 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.149 SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon.

In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Supplementary Information in Relation to the Financial Statements as a Whole

.150 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of GAAS, *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

.151 The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This SAS also may be applied, with the report wording adapted as necessary, when an auditor has been engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Required Supplementary Information

.152 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558), addresses the auditor's responsibility with respect to *required supplementary information*. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. SAS No. 120 explains that the objectives of the auditor, when a designated accounting standard setter requires information to accompany an entity's basic financial statements, are to perform specified procedures in order to

- describe, in the auditor's report, whether required supplementary information is presented and
- communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

Auditing Fair Value Measurements

.153 In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

.154 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820 under U.S. GAAP this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.

- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)

.155 It is also important for the auditor to evaluate the reasonableness of the determination within the fair value hierarchy of inputs. FASB ASC 820 defines *level 1 inputs* as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date; *level 2 inputs* are defined as inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly; and *level 3 inputs* are defined as unobservable inputs for the asset or liability. Further, in some cases the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety. This classification by management has long-reaching effects in the financial statements through the various classification-based required disclosures. Auditors should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. As stated in paragraph .07 of AU section 312, misstatements can result from error or fraud and may consist of a financial statement disclosure that is not presented in conformity with GAAP.

Fair Values of Securities

.156 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective.

.157 When an entity performs its own valuation, procedures to test fair value include the following:

- Assessing the reasonableness of key factors and assumptions
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.158 When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.159 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles.

Auditing Accounting Estimates

.160 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, the impairment analysis, and the estimated useful lives of long lived assets.

.161 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.162 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings, the determination of the reasonableness of management's accounting estimates would be made with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.163 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342. The AICPA has released a proposed redrafted SAS, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* (Redrafted), on auditing accounting estimates, including fair value. Readers are encouraged to remain alert for developments on this topic.

Using the Work of a Specialist

.164 It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

.165 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.

Auditor Responsibilities for Subsequent Events

.166 In September 2009, the AICPA issued TIS section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), which discusses the effects of the entity's responsibility to disclose the date through which the subsequent events have been evaluated on the auditor's responsibilities for subsequent events. This question and answer document was issued in response to FASB's issuance of FASB Statement No. 165, *Subsequent Events* (codified in FASB ASC 855, *Subsequent Events*). Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the auditor's report. This typically will result in the same date being used for both the auditor's report and the date disclosed by management through which they have evaluated subsequent events. The auditor may consider discussing these dating requirements with management in advance of beginning the audit and including any agreed upon understanding in the engagement letter. In accordance with AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1), the auditor has no obligation to make any further or continuing inquiry or perform any other auditing procedures, with respect to the audited financial statements, after the date of the auditor's report, unless new information that may affect the report comes to his or her attention. Recently issued technical questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx. See the "Subsequent Events" section of this alert for discussion of FASB ASC 855.

Communicating Internal Control Related Matters Identified in an Audit

.167 SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), supersedes SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

.168 The SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). In general, SAS No. 115 retains many of the provisions of SAS No. 112. The key differences between the two standards lie in the definitions of *significant deficiency* and *material weakness*.

Definitions of Significant Deficiency and Material Weakness

.169 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are defined in the FASB ASC glossary. The FASB ASC glossary defines *reasonably possible* as when the chance of the future event or events occurring is more than remote but less than likely; *probable* is defined as when the future event or events are likely to occur. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

The Evaluation Process

.170 Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. Further, the severity of a deficiency does not depend on whether a misstatement actually occurred.

.171 The AICPA published the Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Service Organizations

.172 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324) has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. SSAE No. 16 contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, and earlier implementation is permitted. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324. Once the new SAS becomes effective, it will replace the guidance for user auditors currently in AU section 324. SSAE No. 16 is based on the International Auditing and Assurance Standards Board's (IAASB's) International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*, and the new SAS is based on the IAASB's International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.173 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS No. 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA is developing a new Audit Guide, *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*. Both guides are expected to be available for sale in early 2011.

The AICPA is also in the process of drafting communication materials that will help auditors, clients, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

	Title	***Description***
SOC 1	*Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service.
SOC 2	*Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in an SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Compilation and Review Engagements

.174 The AICPA developed a brand new guide, *Compilation and Review Engagements*, which provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

Accounting Issues and Developments

Accounting Standard Update No. 2009-17

.175 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities.* This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

.176 The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This statement also amends consolidation of variable interest entities (VIE) guidance to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

.177 Entities will be required to provide additional disclosures about involvement with VIEs and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a VIE affects the entity's financial statements.

.178 FASB Statement No. 167 retains the scope of previous VIE consolidation accounting guidance, with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140,* which was incorporated into FASB ASC by ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*.

.179 This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a VIE, or both
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

.180 ASU No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*, was issued in February 2010 to defer the consolidation requirements contained in FASB Statement No. 167 for a reporting entity's interest in certain investment funds so that FASB and the International Accounting Standards Board (IASB) could develop consistent guidance on principal and agent relationships as part of their joint consolidation project. The deferral applies to a reporting entity's interest in an entity that has all the attributes of an investment company or for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those followed by investment companies. It also applies to a reporting entity's interest in an entity that is required to comply or operate in accordance with requirements similar to those in Rule 2a-7 of the 1940 Act for registered money market funds. The deferral does not apply in situations when a reporting entity has the explicit or implicit obligation to fund losses of an entity that could potentially be significant to the entity. An entity that qualifies for the deferral will continue to be assessed under the overall guidance on the consolidation of VIEs in FASB ASC 810-10, before FASB Statement No. 167 amendments, or other applicable consolidation guidance.

.181 ASU No. 2010-10 does not defer the disclosure requirements from FASB Statement No. 167. The effective date of this guidance coincides with the effective date of FASB Statement No. 167 (the beginning of a reporting entity's first annual period that begins after November 15, 2009, and for interim periods within that first annual reporting period) and early application is not permitted.

ASU No. 2009-16

.182 Calendar year entities must also start applying the provisions of FASB Statement No. 166 in 2010. FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, requires more information about transfers of financial assets, including securitization transactions, and those circumstances in which entities have continuing exposure to the risks related to transferred financial assets. FASB Statement No. 166 was incorporated into FASB ASC by ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. It is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

.183 Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

.184 The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined by the FASB ASC glossary), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

.185 These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives, depending on the facts and circumstances.

Fair Value

.186 FASB ASC 820-10-20 defines fair value and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity.

Measuring Liabilities at Fair Value

.187 FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*, to increase the consistency in the application of FASB ASC 820 to liabilities. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

.188 This ASU states that, in circumstances in which a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (*a*) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities, or similar liabilities when traded as assets, or (*b*) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. The ASU clarifies that an entity is not required to factor restrictions on the transfer of the liability into the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after its issuance in August 2009. The full text of the ASU can be accessed from FASB's website at www.fasb.org.

Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.189 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both

- does not have a readily determinable fair value. The FASB ASC glossary states that an equity security has a *readily determinable fair value* if it meets any of the following conditions:
  - — The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year. (However, FASB ASC 820 observes that the valuation of a restricted security should be adjusted for the effect of the restriction, even if that restriction terminates within one year.)
  - — The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
  - — The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.
- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes is not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies*.

.190 As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the NAV per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

.191 This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.192 These amendments are effective for interim and annual periods ending after December 15, 2009 and are included in FASB ASC 820-10. An AICPA practice aid, *Alternative Investments—Audit Considerations* also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

.193 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.194 Topics covered in these questions and answers include the following:

- The circumstances when NAV may be used to estimate the fair value of investments as a practical expedient
- How to identify the unit of account for interests in alternative investments
- Considerations for determining whether the reported NAV has been calculated in a manner consistent with FASB ASC 946
- Examples of circumstances when an adjustment to the reported NAV may be necessary
- How to adjust the reported NAV when it is not as of the reporting entity's measurement date
- How to adjust the reported NAV when it has not been calculated in accordance with FASB ASC 946
- The determination of the appropriate level within the fair value hierarchy for NAV of alternative investments in relation to the ability to redeem the investment versus the actual redemption request for the investment
- The definition of *near term* for the purposes of determining the appropriate level within the fair value hierarchy
- The tailoring of disclosure categories to address the nature and risks of investments
- Some considerations for determining the fair value of alternative investments when not utilizing NAV as a practical expedient

.195 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.196 ASU No. 2010-06 was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers among the three levels and the underlying reasons for such transfers would be useful to financial statement users.

.197 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.198 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.199 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Subsequent Declines in Market Value

.200 The AICPA issued TIS section 9070.06, "Decline in Market Value of Assets Subsequent to the Balance Sheet Date" (AICPA, *Technical Practice Aids*), in June 2010 to provide guidance to accountants on the appropriate treatment of declines in the market value of an asset subsequent to the balance sheet date. Through references to FASB ASC 855-10, TIS section 9070.06 clarifies that an entity should only recognize the effects of conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date, but before financial statements are issued or are available to be issued, are specifically identified as an example of a nonrecognized subsequent event.

Business Combinations

.201 TIS section 6910.33, "Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination" (AICPA, *Technical Practice Aids*) was issued to provide guidance to investment companies involved in business combinations after the issuance of FASB Statement No. 141(R), *Business Combinations*. When investment companies engage in a business combination, shares of one company typically are exchanged for substantially all the shares or assets of another company (or companies). Most mergers of registered investment companies are structured as tax-free reorganizations. Following a business combination, portfolios of investment companies are often realigned, subject to tax limitations, to fit the objectives, strategies, and goals of the surviving company. Typically, shares of the acquiring fund are issued at an exchange ratio determined on the acquisition date, essentially equivalent to the acquiring fund's NAV per share divided by the NAV per share of the fund being acquired, both as calculated on the acquisition date. Adjusting the carrying amounts of assets and liabilities is usually unnecessary because virtually all assets of the combining investment companies (investments) are stated at fair value, in accordance with FASB ASC 820, and liabilities are generally short-term so that their carrying values approximate their fair values. However, conforming adjustments may be necessary when funds have different valuation policies (for example, valuing securities at the bid price versus the mean of the bid and asked price) in order to ensure that the exchange ratio is equitable to shareholders of both funds. Only one of the combining companies can be the legal survivor. In certain instances, it may not be clear which of the two funds constitutes the acquirer for financial reporting purposes. TIS section 6910.33 further discusses guidance for business combinations of investment companies, including the following:

- Determining the acquirer for financial reporting purposes
- Form N-14
- Tax implications
- Merger-related expenses
- Cost basis of acquired assets
- Required disclosures
- Illustrative financial statements and disclosures

.202 Recently issued TPAs can be accessed from www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Subsequent Events

.203 FASB Statement No. 165, which has been codified in FASB ASC 855, is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.204 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.205 FASB states that this guidance should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. In September 2009, the AICPA issued TIS section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. Also in September 2009, the AICPA issued TIS section 8700.02, "Auditor's Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), to provide guidance related to the effect of this guidance on the auditor's responsibilities for subsequent events; this is discussed in the "Auditor Responsibilities for Subsequent Events" section of this alert. These questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.206 In February 2010, FASB issued ASU No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, to address questions that arose in practice about potential conflicts between FASB ASC 855 and SEC guidance—specifically, the requirements to disclose the date that the financial statements are issued. This ASU also addresses the intended breadth of the reissuance disclosure provision related to subsequent events.

.207 ASU No. 2010-09 requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market to evaluate subsequent events through the date the financial statements are issued. All other entities must evaluate subsequent events through the date the financial statements are available to be issued. Further, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. Lastly, only non-SEC filers are required to disclose in the revised financial statements the dates through which subsequent events have been evaluated in both the issued or available-to-be-issued financial statements and the revised financial statements. Revised financial statements are considered reissued financial statements.

.208 The amendments in ASU No. 2010-09 are effective upon issuance, except for the use of the issued date for conduit bond obligors. That amendment is effective for interim or annual periods ending after June 15, 2010.

Accounting for Uncertainty in Income Taxes

.209 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.210 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

.211 In June 2010, to clarify some practice issues related to FASB ASC 740-10, the AICPA issued TIS section 5250.15, "Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions" (AICPA, *Technical Practice Aids*). TIS section 5250.15 clarifies that the disclosure requirements in paragraph 15(c)–(e) of FASB ASC 740-10-50 remain in effect (if applicable), regardless of whether an entity has any uncertain tax positions. Those disclosure requirements include the following:

- The total amounts of interest and penalties recognized in both the statement of operations and the statement of financial position
- For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, the nature of the uncertainty, the nature of the event that could occur in the

next 12 months that would cause the change, and an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made

- A description of tax years that remain subject to examination by major tax jurisdictions

.212 Recently issued technical questions and answers of the AICPA can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Accounting for Certain Distributions to Shareholders

.213 In January 2010, FASB issued ASU No. 2010-01, *Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*. This ASU affects entities that declare dividends to shareholders that may be paid in cash or shares at the election of the shareholders with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate. The amendments in this ASU clarify that the stock portion of the distribution that allows the shareholders to elect or receive cash or shares, with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate, is considered a share issuance. The intent is to eliminate observed diversity in practice. These amendments are effective for interim and annual periods ending on or after December 15, 2009, and should be applied on a retrospective basis.

FASB Statement No. 168

.214 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in its financial statements.

Referencing FASB ASC in Your Documentation

.215 You should consider how your entity will reference FASB ASC in your documentation (policies and procedures, technical memoranda, financial statements and filings, engagement working papers, and so on). It is only prudent to reflect current U.S. GAAP in your documentation. The FASB Notice to Constituents includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." Conversely, FASB suggests using the detailed numerical referencing system in working papers, articles, textbooks, and related items.

.216 Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate. It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

.217 However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). A listing of examples of grandfathered guidance can be found in FASB Statement No. 168.

.218 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

Postcodification FASB References

.219 In spring 2010, the AICPA judgmentally selected 50 SEC filers and reviewed their 2009 Form 10-Ks to understand what type of references are actually being used in practice. All financial statements reviewed were for those entities having a fiscal year-end between December 1, 2009, and January 31, 2010, when the FASB codification was fully effective for all of these entities. The entities selected comprised the following:

- Fourteen large accelerated filers (28 percent of the sample)
- Twenty accelerated filers (40 percent of the sample)
- Seven nonaccelerated filers (14 percent of the sample)
- Nine smaller reporting companies (18 percent of the sample)

.220 Of all the entities selected, 50 percent had gone to mostly plain English references in their annual financial statements. However, among these entities, in the "Summary of Significant Accounting Policies" section of the financial statements, many entities did still use specific references to either old FASB standards (pre-FASB Statement No. 168 standards or legacy standards) or specific ASUs, when appropriate. There did not seem to be much of a difference in this percentage among large accelerated filers, accelerated filers, and nonaccelerated filers. However, smaller reporting companies were less likely to use plain English (only 33 percent used plain English references).

.221 As for the remaining 50 percent of filers selected, they chose to use either FASB ASC-specific references (36 percent) or some sort of dual references (12 percent) between the precodification standards and new FASB ASC guidance. One entity continued to use the old FASB references and did not mention FASB ASC in its financial statements.

.222 For those entities using FASB ASC references, most only referenced to the topic level and did not go down to the subtopic or section level. For those using dual references, in most cases, the new FASB ASC topic was listed first, with the historical FASB reference noted parenthetically. See the following table for a full breakout of the results:

	Plain English References	***FASB ASC References***	***Dual References***	***Old FASB References***
Large Accelerated Filers	7	4	2	1
Accelerated Filers	12	6	2	0
Nonaccelerated Filers	3	3	1	0
Smaller Reporting Companies	3	5	1	0
Total Sample	25	18	6	1

.223 The sampling results make it clear that although both FASB and the SEC have stated that the use of plain English is most appropriate when dealing with financial statements and notes to financial statements, not everyone is there yet. It will be interesting to see if the plain English references trend continues upward once entities have had another full year to get used to FASB ASC. In addition, all new guidance issued in 2010 was issued through ASUs, and no legacy standards were issued. Therefore, we would expect that in 2010 filings, even the "Summary of Significant Accounting Policies" section of financial statements would no longer refer to any legacy standards.

.224 We found that with the plain English references, some entities chose instead to say something like, "in accordance with the purchase method of accounting and as updated with FASB's April 2009 additional authoritative guidance for business combinations, we ...." Here the entity uses plain English but also makes it clear which new guidance it is following. This would be most important for those FASB changes with early adoption provisions to make it clear which method an entity used.

.225 FASB has stated that ASUs do not themselves carry any authority; rather, the updates made to the codification once the ASU is effective are authoritative. Therefore, entities would be wise to ensure that when they are referring to authoritative literature, use of either plain English or the FASB ASC references would be appropriate, rather than just naming the ASU that brought about the change in accounting.

.226 In addition, entities would want to be sure that they do not refer to any legacy standards in their 2010 financial statements. Because all changes made to the codification in 2010 were through ASUs, referring to legacy standards is no longer correct. For example, since the codification became effective, there have been several updates to the *Fair Value Measurements and Disclosures* topic. Therefore, referring to FASB Statement No. 157, *Fair Value Measurements*, is no longer accurate because this standard does not incorporate changes made since the codification became effective in 2009. We would expect that entities that used dual references to both the legacy standards and FASB ASC references would not continue to use those dual references in 2010 financial statements.

.227 Many entities also have a section of their notes to financial statements titled "Effect of Accounting Pronouncements Not Yet Adopted." In 2010, we would expect the title of this section to change to something like "Effect of Authoritative Accounting Guidance Not Yet Adopted."

.228 It will be interesting to see if both public and nonpublic entities make any additional refinements or changes to their 2010 financial statements as we move into our first full year with FASB ASC. It is our understanding that the SEC may be issuing comment letters to those entities that are not properly reflecting the current state of U.S. GAAP in their financial statements, whether that be by using plain English or using the new FASB ASC references.

Convergence With International Financial Reporting Standards

.229 Since the signing of the Norwalk Agreement by FASB and the IASB, the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and IFRSs and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

SEC Work Plan for Consideration of IFRSs

.230 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to lay out transparently the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.231 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs

- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.232 IFRS lacks broad guidance for certain industries, including for investment companies. The roadmap excluded investment companies registered under the 1940 Act and certain other entities that are required to file or furnish certain types of financial reports (for example, broker-dealers). The comment letters received gave this exclusion a mixed reaction. Due to these varying opinions, the SEC staff will analyze possible approaches for financial reporting requirements for broker-dealers and investment companies, should the SEC determine in the future to incorporate IFRS into the U.S. financial reporting system. The SEC staff will assess the effects of such incorporation on broker-dealers, investment companies, and investors, including whether IFRS includes sufficient standards, and the extent of, logistics for, and estimated time necessary to undertake any changes, should broker-dealers and investment companies be included in the scope any potential SEC decision. The SEC staff will also evaluate the effect on investors of excluding broker-dealers and investment companies from the scope of any potential SEC decision.

.233 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. Commenters provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

.234 In August 2010, the SEC issued two releases (Release Nos. 33-9133 and 33-9134, *Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS Into the Financial Reporting System for U.S. Issuers*) to solicit public comment on its ongoing consideration of incorporating IFRSs into the financial reporting system for U.S. issuers. The first release contains requests for comment on three topics derived from the work plan that are related to the potential impact on investors. The second release contains requests for comment on three topics, also derived from the work plan, that are related to the potential impact on U.S. issuers. All comments will be available on the SEC's website.

International Financial Reporting Standard for Small and Medium-sized Entities

.235 The IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*) to be a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs. *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability.

.236 The AICPA Governing Council recognizes the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time and effort to convert to *IFRS for SMEs*.

.237 Information about IFRSs and *IFRS for SMEs* can be found at www.ifrs.com. Additionally, to help its membership, the AICPA has developed an IFRS for SMEs—U.S. GAAP Comparison Wiki. The purpose of the Wiki is to provide a detailed and comprehensive comparison of *IFRS for SMEs* with corresponding requirements of U.S. GAAP. But it is more than just a comparison resource—it is a wiki. That means it is a collaborative, ongoing work in progress for anyone to contribute to and use. The Wiki is found at http://wiki.ifrs.com/.

.238 Entities interested in *IFRS for SMEs* or possibly adopting the standard may find it helpful to take the following actions:

- *Monitor the efforts of the AICPA/FAF/NASBA "Blue-Ribbon" Panel on Standard Setting for Private Companies*. For more information about the panel, go to www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156684820.
- *Monitor convergence efforts of FASB and the IASB*.
- *Stay informed on SEC developments*. Public companies will be directly affected by the SEC's decision to adopt IASB standards. The future of private company reporting will also likely be affected by an SEC mandate to adopt IFRSs.
- *Develop a high-level analysis of the potential impact on accounting policies, processes and systems, contracts, legal agreements, and financing and tax structures.*

Private Company Financial Reporting

.239 The AICPA and the Financial Accounting Foundation (FAF) established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel also is sponsored by the National Association of State Boards of

Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities taking more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior to that plan being finalized. The panel will issue a report containing its recommendations to the FAF board of trustees in January 2011. The report will be publicly available, and the resulting action plan is expected to be exposed for public comment prior to the plan being finalized.

.240 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for Private Companies—with enhancements; U.S. GAAP—Baseline GAAP with Public Company Add-Ons; and Separate, Stand-Alone GAAP Based on Current U.S. GAAP. Most of the panel members also expressed their discontent with the current make-up of FASB and its heavy, but appropriate, focus on public companies. This led to another key discussion topic: the structure of whatever model is chosen—the current FASB; a restructured FASB (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of the FAF.

Recent Pronouncements

.241 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.242 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance

Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, vol. 1, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550) Issue Date: February 2010	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the

(*continued*)

Recent Auditing and Attestation Pronouncements and Related Guidance	
(Applicable to audits conducted in accordance with GAAS)	financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801) Issue Date: December 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 801 to reflect changes in the compliance audit environment and incorporates the risk assessment standards. It requires the auditor to adapt and apply the AU sections of the AICPA's *Professional Standards* to compliance audits and provides guidance on how to do so. It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Interpretation No. 1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9501 par. .01–.07) Issue Date: September 2010 (Interpretive publication)	For insured depository institutions (IDI) that require an examination of internal controls at the IDI level, this interpretation addresses whether the auditor can meet the integrated audit requirement when an IDI does not prepare financial statements for external distribution and, if so, how the auditor can report on the effectiveness of the IDI's internal control over financial reporting.
Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (subject to approval by the Securities and Exchange Commission [SEC]) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.
PCAOB Auditing Standard No. 14, *Evaluating Audit Results* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether the auditor has obtained sufficient appropriate audit evidence. The evaluation process set forth in this standard includes, among other things, evaluation of misstatements identified during the audit; the overall presentation of the financial statements, including disclosures; and the potential for management bias in the financial statements.
PCAOB Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements for responding to the risks of material misstatement in financial statements through the general conduct of the audit and performing audit procedures regarding significant accounts and disclosures.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. The risk assessment process discussed in the standard includes information-gathering procedures to identify risks and an analysis of the identified risks.
PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard sets forth requirements for supervision of the audit engagement, including, in particular, supervising the work of engagement team members. It applies to the engagement partner and to other engagement team members who assist the engagement partner with supervision.
PCAOB Auditing Standard No. 9, *Audit Planning* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan.
PCAOB Auditing Standard No. 8, *Audit Risk* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement.

Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 162) Issue Date: January 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard and its related amendments supersede the interim concurring partner review requirements and update the interim quality control standards. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB. The standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. It is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009.
PCAOB Staff Question and Answer, *Auditing Standard No. 7,* Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) Issue Date: February 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This staff question and answer provides further implementation guidance on the documentation requirements of Auditing Standard No. 7 (AU-P sec. 162) in light of comments the SEC received during its comment period.
PCAOB Staff Audit Practice Alert (PA) No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06) Issue Date: July 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert is intended to remind registered public accounting firms of their obligations when using the work of other firms or using assistants engaged from outside the firm. The alert was prompted by observations by the PCAOB that a number of registered public accounting firms located within the United States have been issuing reports on financial statements filed by issuers that have substantially all of their operations outside of the United States, and some of these firms may not be conducting those audits in accordance with PCAOB standards.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Staff Audit PA No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05) Issue Date: April 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert explains that significant unusual transactions, especially those close to period-end that pose difficult substance over form questions, can provide opportunities for entities to engage in fraudulent financial reporting. This staff audit practice alert is designed to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions.

Recent ASUs

.243 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC)	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*

Recent Accounting Standards Updates	
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2009-13 (October 2009)	*Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2009-12 (September 2009)	*Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*

(*continued*)

Recent Accounting Standards Updates	
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-03 (January 2010)	*Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*
ASU No. 2009-14 (October 2009)	*Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*

Recently Issued Technical Questions and Answers

.244 The following table presents a list of nonauthoritative accounting and audit and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

***Recently Issued Technical Questions and Answers* (AICPA, *Technical Practice Aids*)**	
Accounting	
Technical Questions and Answers (TIS) section 6910.18 (amended October 2010)	"Disclosure of an Investment in an Issuer When One or More Securities and/or One or More Derivatives are Held"

Recently Issued Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
Accounting — continued	
TIS section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820,

(*continued*)

***Recently Issued Technical Questions and Answers* (AICPA, *Technical Practice Aids*)**	
Accounting — continued	
	Fair Value Measurements and Disclosures, to Certain Financial Instruments"
TIS section 6910.33 (December 2009)	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"
TIS section 2220.27 (December 2009)	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 2220.26 (December 2009)	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.25 (December 2009)	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"
TIS section 2220.24 (December 2009)	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.23 (December 2009)	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.22 (December 2009)	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.21 (December 2009)	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.20 (December 2009)	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"
TIS section 2220.19 (December 2009)	"Unit of Account"
TIS section 2220.18 (December 2009)	"Applicability of Practical Expedient"
TIS section 6910.32 (July 2009)	"Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt"
TIS section 6910.31 (July 2009)	"The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the '5 Percent Test' Described in TIS Section 6910.30"
TIS section 6910.30 (July 2009)	"Disclosure Requirements of Investments for Nonregistered Investment Partnerships When

***Recently Issued Technical Questions and Answers* (AICPA, *Technical Practice Aids*)**	
Accounting — continued	
	Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets"
TIS section 1600.04 (June 2009)	"Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements"
TIS section 1500.07 (June 2009)	"Disclosure Concerning Subsequent Events in OCBOA Financial Statements"
Audit and Attest	
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 8700.02 (September 2009)	"Auditor Responsibilities for Subsequent Events"
TIS section 8700.01 (September 2009)	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"

Recent AICPA Independence and Ethics Developments

.245 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.246 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of Nonattest Services" under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05). Interpretation

No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client.

.247 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

On the Horizon

.248 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the investment companies industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.249 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.250 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the past few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* and 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

.251 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence" and the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Interim Financial Information

.252 In July 2010, the ASB issued two proposed SASs on interim financial information. The first, *Revised Applicability of Statement on Auditing Standards No. 116*, Interim Financial Information, is intended to revise paragraph 5 of SAS No. 116 (AICPA, *Professional Standards*, vol. 1, AU sec. 722), so that the guidance in SAS No. 116 would be applicable when the auditor audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. Currently, the guidance in SAS No. 116 is applicable when the auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements (and, therefore, is not applicable when the auditor expects that a new auditor may be engaged for the current year). This proposed amendment would be effective for reviews of interim financial information for periods beginning after December 15, 2011, with early implementation permitted. Comments are due by October 8, 2010.

.253 The second proposal on interim financial information, *Interim Financial Information* (Redrafted), would supersede SAS No. 116 and represents the redrafting of the guidance to apply clarity drafting conventions. The main changes to existing standards are as follows:

- Replacement of the term *accountant* with *auditor*
- The change to paragraph 5 discussed in the prior paragraph
- Requirement of the auditor to issue a written report unless the review of the interim financial information is required by a third party and the third party does not require a written review report
- Allowance of oral reports for entities that are subject to external requirements to report in a manner that is substantially similar to the reporting required of issuers, pursuant to PCAOB standards
- Requirement for the auditor to perform procedures consistent with those required for acceptance of an engagement to audit financial statements

- Requirement for the review report to include a statement that the review of interim financial information was conducted in accordance with auditing standards generally accepted in the United States of America

.254 This proposed SAS would be effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012. Comments for this proposed SAS are also due by October 8, 2010.

Exposure Drafts on Auditor's Reports

.255 The ASB issued three proposed SASs related to auditor's reports: *Forming an Opinion and Reporting on Financial Statements*, *Modifications to the Opinion in the Independent Auditor's Report*, and *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. These proposed standards are drafted with the ASB's clarity drafting conventions and are intended to converge with ISAs. The intent of issuing three separate SASs is to assist practitioners in identifying and applying the reporting requirements and guidance. The ASB has made various changes to the related ISAs to tailor them to the U.S.; however, these changes have not been substantial in nature.

.256 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Exposure Drafts on Special Considerations Audits

.257 Another exposure draft issued by the ASB contains two proposed SASs: *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* and *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. These proposed standards have been drafted with the clarity drafting conventions and are intended to converge with the equivalent ISAs. No meaningful differences exist between these proposed standards and the ISAs. *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* addresses the application of GAAS to financial statements prepared under the cash, tax, regulatory, or contractual bases of accounting. It also replaces the term *other comprehensive basis of accounting* with *special purpose framework*.

.258 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* introduces new planning, performance, and reporting requirements for these engagements. The proposed SAS also clarifies that a single financial statement and a specific element of a financial statement include the related notes.

.259 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Auditing and Attestation Pipeline—Issuers

Confirmations

.260 The PCAOB has proposed a draft auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard, AU-P section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Standards), and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax, e-mail, through an intermediary, or direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other media.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.261 In drafting this proposed standard, the PCAOB considered the guidance contained in ISA 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations. This standard is anticipated to be effective for auditors for fiscal years ending on or after December 15, 2011.

Communications With Audit Committees

.262 In March 2010, the PCAOB proposed for comment an auditing standard on *Communications with Audit Committees* and a series of related amendments to its interim standards that are intended to (*a*) enhance the relevance and effectiveness of the communications between the auditor and the audit committee and (*b*) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. Two of the new requirements would be for the auditor (*a*) to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in the engagement letter and (*b*) to evaluate the adequacy of two-way communication between the auditor and audit committee. Additionally, the proposal also includes requirements for the auditor to communicate with the audit committee regarding the following:

- An overview of the audit strategy and timing of the audit, including a discussion of significant risks; the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit
- Critical accounting policies, practices, and estimates
- The auditor's evaluation of the entity's ability to continue as a going concern

.263 The proposed standard would become effective, subject to SEC approval, for audits of fiscal years beginning after December 15, 2010.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.264 The year 2010 has been a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Balance Sheet Netting
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Statement of comprehensive income
- Discontinued operations

.265 A progress report for the quarter ended March 31, 2010, highlighted the following topics: (*a*) on the financial instruments topic, the boards have reached different conclusions on significant technical issues that may affect the project timetable and (*b*) the boards agreed to explore an alternative approach to lessor accounting that may affect the project timetable of this topic. In March 2010, the exposure draft *Conceptual Framework for Financial Reporting* was published for public comment. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

.266 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

.267 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Comprehensive Income Exposure Draft

.268 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other comprehensive income. In that financial statement, the components of net income and the components of other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.269 Also, in May 2010, FASB issued a proposed ASU on accounting for financial instruments, derivative instruments, and hedging activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments; removes the threshold for recognizing credit impairments, creating a single credit impairment model for both loans and debt securities; and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.
- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, a reconciliation from amortized cost to fair value would be required on the statement of position; with the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period. Therefore, net income will remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period.
- The existing "probable" threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. *Probable* is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur.)
- For changes in the value of financial instruments measured through other comprehensive income, an entity is required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected, which would better reflect a financial instrument's interest yield.

- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.270 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments).

.271 For investment companies, the areas of focus are the changes to accounting for financial liabilities, money market funds, and transaction costs. The proposed guidance would require financial liabilities of investment companies to be measured at fair value with changes in fair value recognized as a net increase (decrease) in net assets. Neither the option to report changes in the fair value of a qualifying financial asset or financial liability in other comprehensive income nor the amortized cost option for qualifying financial liabilities would be available to an investment company. FASB believes that recognizing changes in fair value in net assets resulting from operations would provide the most relevant information for users of their financial statements. The proposed guidance would also require money market funds that comply with Rule 2a-7 of the 1940 Act to measure their investments at fair value rather than amortized cost. Further, the proposal to expense all transaction costs rather than capitalize certain costs as part of the initial fair value measurement of financial assets would be a significant change for investment companies that would affect their expense ratios. These proposed changes would affect the guidance contained in subtopics 320, 323, and 405 of FASB ASC 946.

.272 This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued two exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each board's exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence.

.273 The effective date of these amendments will be established upon issuance of the final ASU, which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional four years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

.274 FASB has issued frequently asked questions for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. This document can be accessed at www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157295447.

Revenue Recognition Exposure Draft

.275 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from Contracts with Customers*, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.276 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).
- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.277 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.278 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period.

Fair Value Exposure Draft

.279 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.280 The first two of these significant amendments are intended to clarify the application of existing fair value measurement guidance. The last three of these significant amendments would change a particular principle of fair value guidance.

.281 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.282 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

.283 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.284 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities) in an active market. This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price in an active market. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 or level 3 of the fair value hierarchy.

.285 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a level 3 fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances (excluding unquoted equity instruments, as provided by FASB's financial instruments exposure draft discussed previously)
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.286 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011.

Financial Statement Presentation Staff Draft

.287 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address users' concerns that existing requirements permit too many alternative types of presentation and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.288 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.289 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*; 962, *Plan Accounting—Defined Contribution Pension Plans*; and 965, *Plan Accounting—Health and Welfare Benefit Plans* or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.
- Presentation of business and financing activities would be separated as follows:
  - — The business section would include items that are part of an entity's daily operations and other income generating activities.
  - — The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.
- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.290 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The proposal would define, and provide the requirements for a complete set of financial statements. Currently, a complete set of financial statements for the period is defined only in the FASB Concepts Statements. An entity would also be required to present one period of comparative information. A *complete set of financial statements* would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.291 The boards' tentative decisions on financial statement presentations do differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

Investment Companies Joint Project

.292 FASB and the IASB also have a project on their agenda with the objective of providing comprehensive guidance for addressing whether an entity is an investment company and providing measurement requirements for an investment company's investments. The boards have reached the following decisions on this project:

- When preparing consolidated financial statements, the parent of an investment company (if it is not an investment company) should be prohibited from retaining the fair value accounting of the investment company.
- A parent of an investment company is required to consolidate all entities that it controls, including those that are controlled by an investment company subsidiary, unless that parent is an investment company itself.
- If a reporting entity has an interest in an investment company that it accounts for using the equity method, it should retain the fair value accounting of the investment company.

.293 The boards have tentatively decided on the criteria to classify as an investment company. These criteria are as follows: (*a*) the express business purpose is investing for current income, capital appreciation, or both; (*b*) potential exit strategies and a defined time (or range of dates) for which to exit the investment have been identified; (*c*) substantially all of the entity's activities are investment activities carried out for its express business purposes; (*d*) unit ownership; (*e*) pooling of funds; (*f*) the investments are managed and their performance evaluated (both internally and externally) on a fair value basis; (*g*) the entity is a reporting entity; and (*h*) any providers of debt to the investees of the entity do not have direct recourse to any of the entity's other investees.

.294 FASB has tentatively decided that an investment company must measure all of its investments at fair value. The IASB tentatively decided that an investment company must measure investments in entities that it controls at fair value through profit or loss. Further, an investment company should disclose whether it has provided any financial or other support to any of its controlled investees that it was not previously contractually required to provide and the nature and extent of any significant restrictions on the ability of its controlled investees to transfer funds to the investment company. An investment company should not be required to present summarized financial information for controlled investments.

.295 Regarding transition, FASB tentatively decided that an entity currently applying the guidance in FASB ASC 946 that no longer qualifies as an investment company should discontinue the application of that guidance. This change would be applied prospectively from the date the revised consolidation requirements are first applied. For investees that are required to be consolidated as a result of an entity no longer qualifying as an investment company, the entity should apply the same transition guidance for all other entities that will be required to be consolidated as a result of the revised consolidation requirements. Both boards tentatively decided that an entity that was not previously considered an investment company, but that would be under the new criteria, should recognize its investments in entities that it controls at fair value on the date that it first applies the revised consolidation requirements, with an adjustment made to retained earnings.

.296 An exposure draft is scheduled for release during the fourth quarter of 2010, with a final document expected in the second quarter of 2011. The boards specifically asked that it be clear that significant third-party investment is required for an entity to be an investment company.

Leases Exposure Draft

.297 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a "right of use" approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, therefore providing more complete and useful information to investors and other users of financial statements. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and an obligation. Under the proposed guidance, lessees would only have one method of accounting for leases, which would produce more complete and comparable financial reporting in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.298 The scope of the new lease guidance includes all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. Under this new guidance, all lessees would use a single method of accounting for all leases: an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the right-of-use asset), and a liability at the present value of the expected lease payments would also be recognized.

.299 A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.

- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

.300 For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.301 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties since that discussion paper. The comment period is open until December 15, 2010. During the comment period, the boards will undertake further outreach activities, including public round-table meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all comment letters received. A final standard is expected in the second quarter of 2011. The AICPA has developed questions and answers to highlight the important aspects of the proposals, which can be located at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/EDITED_LEASES_FAQ.pdf.

Insurance Contracts Discussion Paper

.302 In June 2010, the IASB issued an exposure draft of a proposed IFRS that would apply to all insurance contracts written by both insurance entities and noninsurance entities. Three months later, FASB issued a discussion paper to solicit broad-based input on how to improve, simplify, and converge the financial reporting requirements for insurance contracts. The solicited feedback is focused on (*a*) whether the IASB's proposal would be a sufficient improvement to U.S. GAAP to justify the cost of change; (*b*) whether the project goals of improvement, convergence, and simplification would be more effectively achieved by making targeted improvements to existing U.S. GAAP (rather than issuing comprehensive new guidance); and (*c*) certain critical accounting issues for which the preliminary views of FASB differ from the IASB's exposure draft. It is important to remember that although the project on insurance contracts is a joint project, it is not part of the boards' MoU.

.303 The discussion paper summarizes the key aspects of the IASB's exposure draft and compares the proposed changes with both the alternative preliminary views of FASB and the current guidance in FASB ASC 944, *Financial Services—Insurance*. FASB decided to issue a discussion paper rather than an exposure draft because of the following reasons:

- The extent of FASB's and the IASB's current accounting guidance for insurance contracts varies significantly; U.S. GAAP comprehensively addresses accounting for insurance contracts by insurance entities, whereas IFRSs do not have comprehensive guidance. Further, the boards have not explicitly evaluated whether the model proposed in the IASB's exposure draft would represent an improvement to U.S. GAAP.
- FASB has not determined whether one model or two models would result in more useful information about insurance contracts. FASB

would like additional input from stakeholders on whether different types of insurance contracts warrant different recognition, measurement, and presentation and, if so, what criteria should be used for determining which, if any, types of insurance contracts would use each model.

- FASB is considering whether employer-provided health insurance should be included within the scope of the insurance contracts project and how recent U.S. health care reform may affect the application of the different approaches.

.304 The discussion paper also includes a listing of common elements of U.S. GAAP on insurance contracts that some stakeholders note could be improved. The appendix of the discussion paper compares the main areas of current U.S. GAAP for insurance contracts, the IASB's proposed approach, and FASB's preliminary views that differ from the proposed approach included in the IASB's exposure draft. Comments are due by mid-December 2010. Additionally, FASB and the IASB plan to host a series of public roundtable meetings in December 2010 to hear stakeholders' views. Readers should be alert for developments on this topic.

Auditing Considerations of Accounting Convergence

.305 Although the future of convergence between IASB and FASB accounting standards remains an unknown, discussions have already begun about the potential impact on auditors. Although auditors are accustomed to new standards, the nature and volume of these changes will likely pose new challenges. Among others, some of these potential challenges include the following:

- Training audit staff on a large amount of new accounting guidance that is based on an accounting approach (that is, principles based versus rules based)
- Developing, as necessary, any new internal audit guidance, such as firm methodology
- Implementing any new resulting auditing rules
- Creating a new framework for documenting audit conclusions on a principles-based accounting approach
- Audit committees learning new accounting guidance to effectively perform their function

.306 In addition to the challenges auditors will face, the effects on preparers will also be great. At the time of this writing, it appears that the transition timeline to convergence will be relatively short; this will divert resources during the preparation of financial statements as entities focus on implementing the new principles, which may result in increased audit risk. Auditors, in addition to preparers, are also encouraged to remain current on developments of international accounting convergence.

FASB Accounting Pipeline

Disclosure of Certain Loss Contingencies

.307 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.308 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the PCAOB, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in September 2010.

Going Concern FASB Project

.309 Currently, the only guidance on going concern resides in the auditing literature, and this project's intention is to incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis
- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.310 A revised exposure draft is expected to be issued in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Other Accounting Projects

.311 Additionally, FASB has the following projects underway:

- Troubled debt restructuring
- Disclosure framework
- Investment properties

CFTC On the Horizon

Depository Acknowledgement Letters

.312 In August 2010, the CFTC proposed amending Regulations 1.20, 1.26, and 30.7 concerning the acknowledgment letters that a FCM or derivatives clearing organization must obtain from any depository holding its segregated customer funds or funds of foreign futures or foreign options customers. The proposal sets out standard template acknowledgment letters that reaffirm and clarify the obligations depositories incur when accepting segregated customer funds. The comment period will last 30 days following publication in the *Federal Register*.

Investment of Funds Deposited With Clearing Organizations and FCMs

.313 In 2009, the CFTC issued an advance notice of proposed rulemaking seeking public comment on possible changes to its regulations regarding the investment of customer funds segregated pursuant to Section 4d of the Commodity Exchange Act and funds held in an account subject to Regulation 30.7. Comment letters received have been analyzed, and a formal proposal is being circulated for CFTC approval.

Dodd-Frank Act

.314 On July 21, 2010, the CFTC released the list of 30 areas of rulemaking to implement the Dodd-Frank Act. Some of these areas will require only one rule, while others may require more. The CFTC is required to complete these rules generally in 360 days, though some are required to be completed within 90, 180, or 270 days.

.315 The rule-writing areas have been divided into eight groups: Comprehensive Regulation of Swap Dealers & Major Swap Participants; Clearing; Trading; Data; Particular Products; Enforcement; Position Limits; and Other Titles.

.316 The CFTC is requesting input from the public on each of the rule-writing areas. Instructions for submitting views can be accessed on the individual rule-writing pages on the CFTC's website at www.cftc.gov/LawRegulation/OTCDerivatives/.

Agreed Upon Procedures Report

.317 CFTC staff is developing, in conjunction with industry and independent auditors, an "Agreed Upon Procedures" report for the segregation and secured amount schedules included in an FCM's annual audited financial report. The report is designed to provide greater assurance that FCMs are complying with the regulatory requirements surrounding the segregation and secured computations that are included in the annual report.

Resource Central

.318 The following are various resources that practitioners engaged in the investment companies industry may find beneficial.

Publications

.319 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Investment Companies* (2010) (product no. 0126210 [paperback], DIN-XX [CD-ROM], or WIN-XX [online])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- Checklist Supplement and Illustrative Financial Statements *Investment Companies* (product no. 0089410 [paperback] or WIS-CL [online])
- *Accounting Trends & Techniques, 63rd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (product no. 006639 [paperback] or WFM-XX [online])
- Audit and Accounting Practice Aid *Independence Compliance: Checklists and Tools for Complying With AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660 [paperback] or WSC-XX [online])

- Financial Reporting Alert *Current Economic Crisis: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.320 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification*™, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]). To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.321 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

.322 Visit www.cpa2biz.com for a complete list of CPE courses.

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.323 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

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.324 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

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Hotlines

Accounting and Auditing Technical Hotline

.326 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.327 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

The Center for Audit Quality

.328 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.329 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQ.aspx.

AICPA Industry Expert Panel—Investment Companies

.330 For information about the activities of the AICPA Investment Companies Expert Panel, visit the panel's website at www.aicpa.org/interestareas/accountingandauditing/community/investmentcompanies/Pages/Investment Companies.aspx.

Industry Websites

.331 The Internet covers a vast amount of information that may be valuable to auditors of investment companies, including current industry trends and developments. Some of the more relevant sites for auditors with investment companies as clients include those shown in the following table:

Organization	***Website***
Commodity Futures Trading Commission	www.cftc.gov/
Financial Industry Regulatory Authority	www.finra.org/index.htm
Independent Directors Council	www.idc1.org
Investment Company Institute	www.ici.org/
Mutual Fund Directors Forum	www.mfdf.com/
Securities and Exchange Commission	www.sec.gov/

.332 The investment company practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	***Content***	***Website***
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org

(*continued*)

Website Name	***Content***	***Website***
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov

Website Name	*Content*	*Website*
SEC Division of Investment Management	Contains links to, among other things, responses to frequently asked questions on a number of topics, recent no-action and interpretive letters, and a bibliography of valuation guidance for registered investment companies	www.sec.gov/divisions/investment.shtml